Planning & Implementing Simple Options Strategies in Client Portfolios

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Define the goal with investor

- Easier said than done…
  - Market view
  - Risk profile
  - Sophistication/knowledge
- Options can be used to implement a wide range of market views according to a specific risk profile:
  - Pure hedge against a particular risk (protection)
  - Enhanced upside
  - Enhanced yield
  - Access
- However, even simple options can be complex to understand, especially for investors without finance background
- Maybe an easier way is to go through actual examples of strategies based on some market views and risk profiles

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Unwanted risks and exposures

- Essential part of the implementation. Investors need to clearly understand these risks beyond reading the traditional risks disclosure
- Main risks are:
  - Credit risk (except for listed derivatives)
  - Loss of investment
  - Lower returns
  - Limited liquidity (except for listed derivatives to some extent)
- But there are others equally important:
  - MTM risk before expiry
  - Exposure to other parameters that are not always easily observable nor understandable (implied volatility, interest rates, dividends, time value, correlation, proxy-hedge/underlying…)
- Unless this part of the education is done properly, using derivatives can result in a bad experience and/or inappropriate use

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Assessing the result during the life and at expiry

- The end result always needs to be put back in relation to the initial goal or market view.
  - For example, an investor buying a simple put on an underlying for protection purposes may not be happy if the put matures worthless (he lost the option premium and underperforms the underlying)
  - Another common example relates to call overwriting (selling a slightly out of the money call on an underlying). If the underlying rises above the strike of the call sold, then the investor will underperform the underlying, potentially even after taking into account the initial yield generated
- Sometimes the strategy may not be as effective as hoped even if the initial market view was correct due to exposure to other parameters, the usage of a proxy-underlying or even due to the way the strategy is implemented (futures roll etc)
- Many issues around the MTM, which may not be easily explained due to the impact of a lot of parameters: volatility, forwards, rate, etc.

How to promote these strategies

- Education/workshops
  - The more investors understand these strategies, the more they will be comfortable with implementing them
  - Make some simple strategies part of the daily product offering. This will allow investors to see price consistency etc
  - The goal being that after a successful experience, investors will tend to be willing to consider again
- Maybe a focus on transparency initially could convince some investors. The use of listed derivatives may work well in order to have potentially better liquidity and pricing transparency
- Maybe start with indices as underlying in order to increase transparency, liquidity and minimize the exposure to other parameters (or their significance)
- Initial focus on simple and easy to understand strategies with clear embedded risks
- Highlight key benefits: tailor-made strategies, diversification, lower risk profile etc.

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Where do these strategies fit in a portfolio

- Depends on the initial goal
  - A hedging strategy should fit with the asset it is hedging. For example, a put on an equity index should fit within the equity component
  - It sometimes may be better to implement strategies at a portfolio level rather than on a single asset class (correlation etc)
  - A traditional access strategy also fits within similar assets
- However, the strategies that alter significantly the risk profile and/or give access to “unusual” underlying (volatility, spreads etc) should maybe fit in a separate component or with alternative assets
- Yield strategies can sometimes have more similarities with fixed income rather than with the actual underlying of the strategy (equity for example) depending on the amount of leverage and optionality

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Additional complications

- Documentation
  - Listed vs. OTC
  - Compliance/suitability
  - Regulation
- Minimum size for each trade especially for OTCs
- Delivery vehicle (listed, OTC, notes, certificates)
- Transparent and regular MTM
- Potential tax consequences

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Strategy 1: Bull Call Spread

- Buy an ATM call and sell an OTM call on the same underlying and with the same expiry, which lowers the cost of the strategy
- The strike of the OTM call can be calibrated to:
  - Lower the cost of the strategy (lower strike => less upside)
  - Increase the upside (higher strike => more expensive)
- Leverage can be added by buying more than 1 ATM call (additional cost)
- Market view: bullish up to the cap (a bullish view can be implemented through a Bull Put Spread as well)
- Risks & exposures:
  - Returns are capped
  - Credit risk
  - MTM will be exposure to various parameters
  - Liquidity although this simple strategy can easily be implemented with listed options
  - Investors can lose the entire investment (increased if leveraged)

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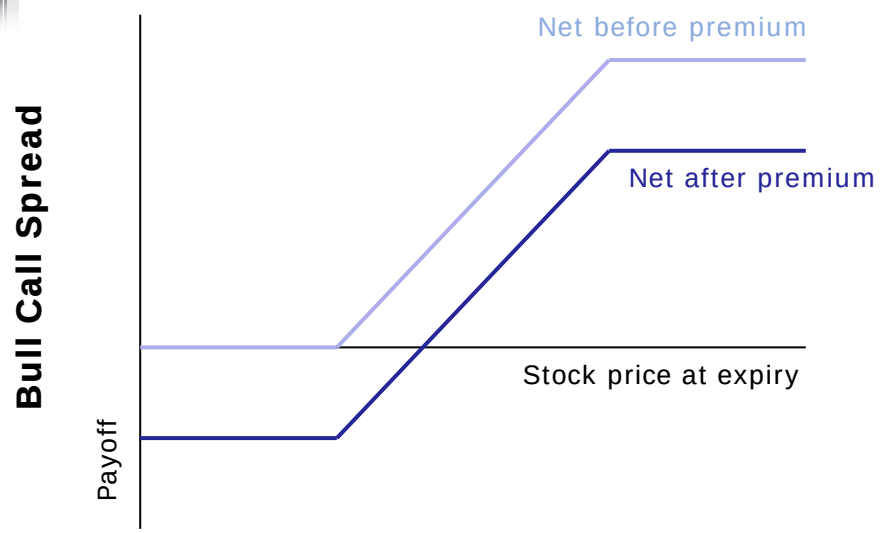
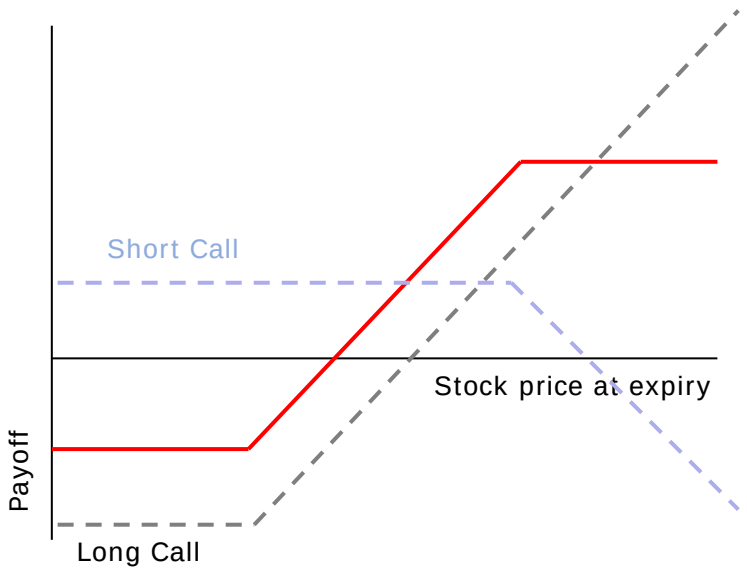
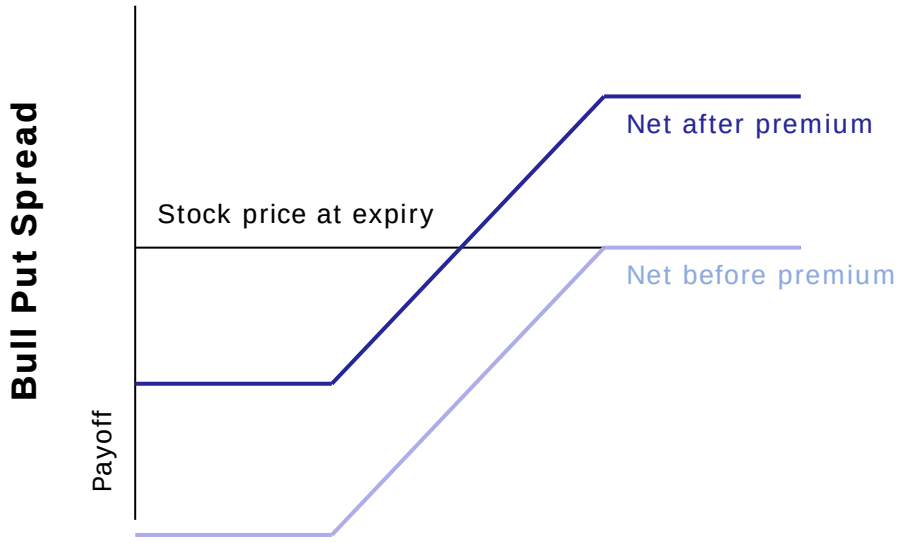
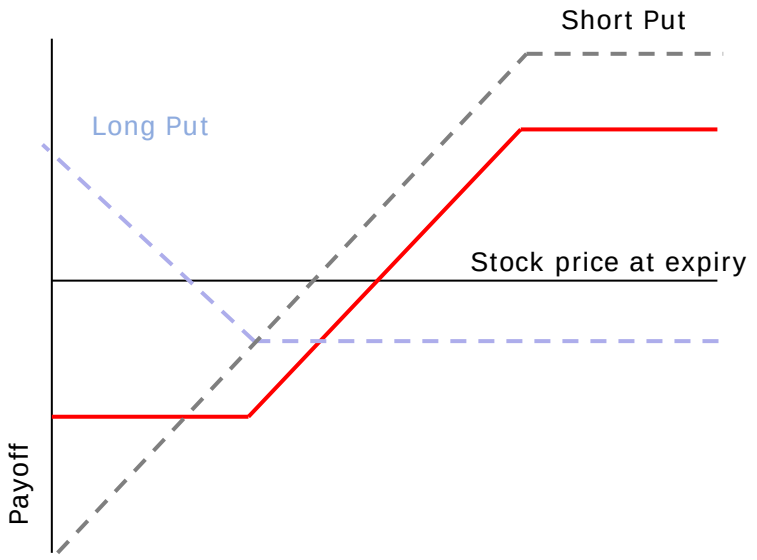
Strategy 1: Bull Call Spread









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Strategy 2: Call Overwrite

- Sell slightly OTM call combined with a long position on the same underlying
- The strike of the OTM call can be calibrated to:
  - Increase the yield of the strategy (lower strike => less upside)
  - Increase the upside (higher strike => lower yield)
- Leverage can be added by selling more than 1 OTM call (additional yield but downside risk is more than 1-to-1)
- Market view: slightly bullish (up to the cap) and slightly bearish
- Risks & exposures:
  - Returns are capped
  - Credit risk
  - MTM will be exposure to various parameters
  - Liquidity although this simple strategy can easily be implemented with listed options
  - Investors can lose money. Protection to the extend of the additional yield generated

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Strategy 2: Call Overwrite

- Additional rationale/tweaks:
  - Downside performance is cushioned by the collected premium
  - The net effect is a reduction in the range of returns and thus overall volatility
  - Systematic selling of short dates options would benefit from a gradual rise of volatility as selling each new option would generate a higher premium
  - Major market index options traded persistently at a significant premium to fair value (due to structural inefficiencies such as more buyers of protection than sellers)
  - Sell ATM vs. OTM short-term calls to capture the most option volatility as ATM calls tend to have the highest vega for short dated (option richness historically has more than offset the absence of capital appreciation) especially on broad market indices
  - Sell 1M call vs. longer dated calls:
    - Capture a trend of rising volatility
    - Higher theta (time decay) for short-dated options works in favor of option sellers
    - On an annualised basis, selling twelve 1M options would generate more option premium and capture more volatility richness than one 12M option

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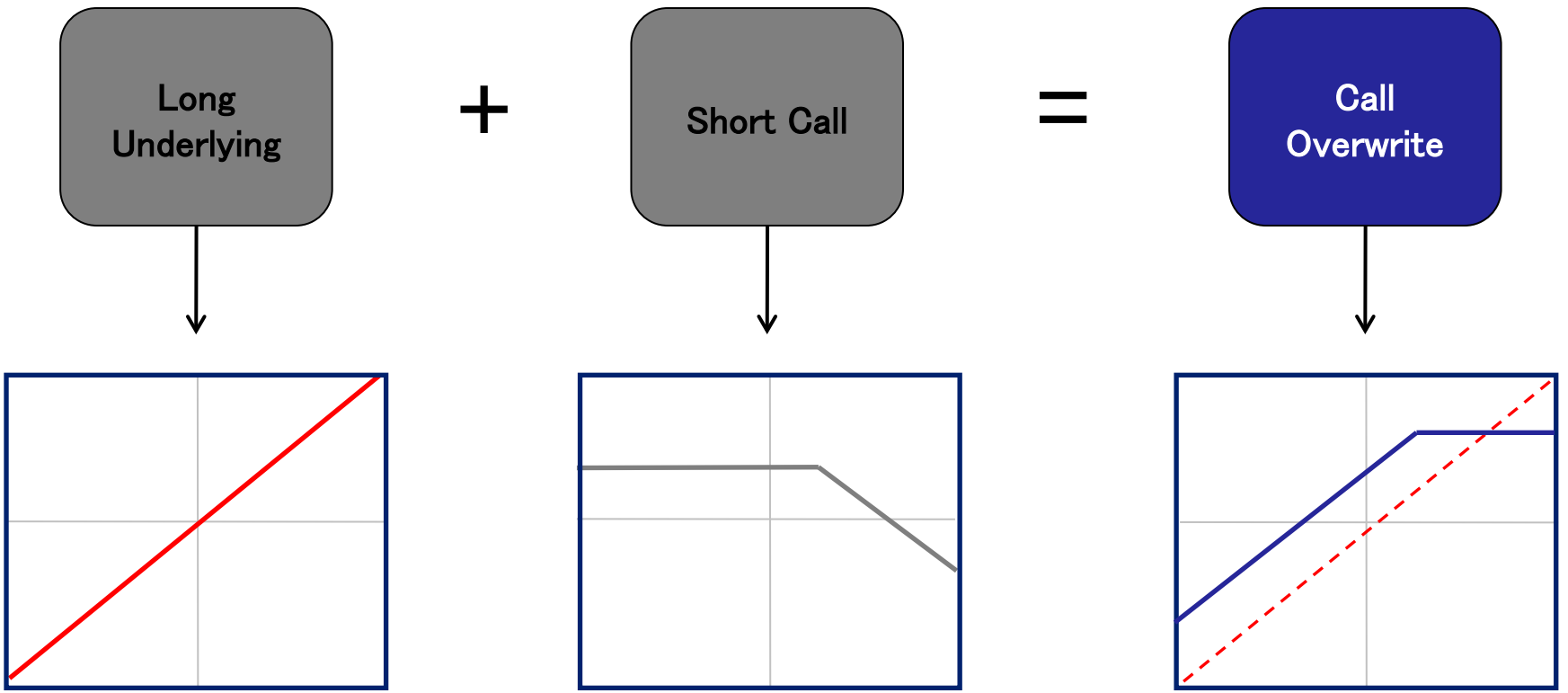
Strategy 2: Call Overwrite



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Strategy 3: Collar

- Buy a put and sell a call on the same underlying and with the same expiry, combined with a long position on the underlying. The premium received on the call lowers the cost of the put
- The strike of the call and put can be calibrated to:
  - Lower the cost of the strategy all the way down to zero (zero-cost collar)
  - Increase the cap (the strike of the call) in order to get more upside (more expensive) or vice versa
  - Increase the floor (the strike of the put) in order to get more protection (more expensive) or vice versa
- Market view: mildly bearish or investors want to protect only against a sharp drop in the underlying without paying too much (in terms of premium)
- Risks & exposures:
  - Returns are capped
  - Credit risk
  - MTM will be exposure to various parameters
  - Liquidity although this simple strategy can easily be implemented with listed options
  - Investors can lose the entire investment (the net cost of the options if any)

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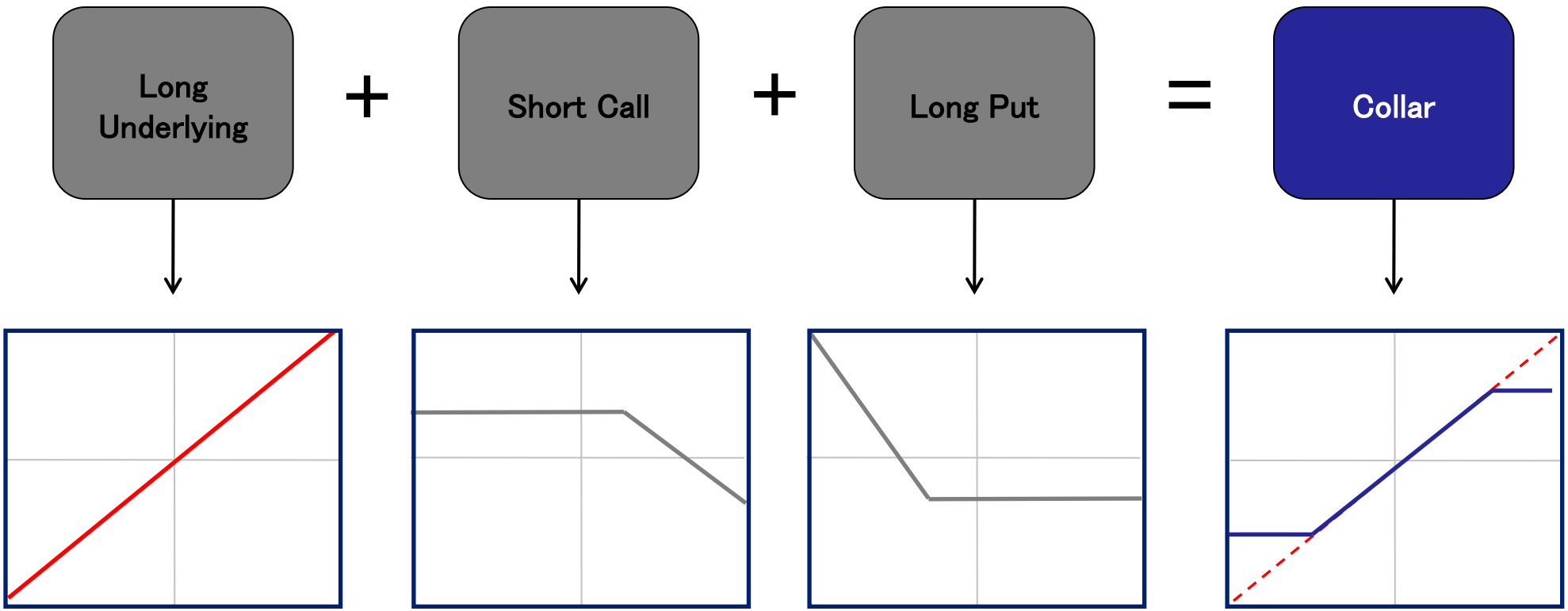
Strategy 3: Collar



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