February 2021 Newsletter

Dear Investor,

The Global Volatility Summit ("GVS") brings together volatility and tail hedge managers, institutional investors, thought-provoking speakers, and other industry experts to discuss the volatility markets and the roles volatility strategies can play in institutional investment portfolios. The GVS aims to keep investors updated on the volatility markets throughout the year, and educated on innovations within the space.

Capstone Investment Advisors has provided the latest piece in the GVS newsletter series.

Cheers,
Global Volatility Summit

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CAPSTONE INSIGHTS

Ahead of the curve: Options trading as a portfolio diversifier: pilot or passenger?

Featured in Investments & Pensions Europe

Jason Goldberg, Senior Portfolio Manager

Ahead of the Curve

Options trading as a portfolio diversifier: Pilot or Passenger?

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Featured in Investment & Pensions Europe

Rising levels of correlation among asset classes coupled with the perennial low rates for fixed income are forcing asset allocators to be more creative in their pursuit of diversification. Some large institutional investors with long-term liabilities to match have begun to consider using options, a direct means of managing the return distribution of equities.

However, options trading can be misunderstood, and therefore overlooked, meaning that investors are missing out on a means of diversification.

It is worth considering where the value of these strategies lie as portfolio diversifiers.

Professional option traders do not try to predict the future. Instead, they invest in strategies that can do well in many different potential futures.

Consider the experience of an airline pilot with that of passengers. The pilot is the professional options trader and the passengers are those who use options like many investors do: buying options to hedge, or selling options to generate income.

The passengers do not care about the exact flight path the plane takes from New York to Los Angeles, or the speed flown, just as outright sellers of a call option on a stock do not care if it almost went in the money prior to maturity. They only care if the call finished out-of-the-money, so that they can keep the premium. The professional options trader, like the pilot, cares very much about the exact path and speed of the plane.

Why? And why is the expertise of an options trader – a skilled pilot – useful in the context of a portfolio?

One reason is liquidity. In a high volatility environment, liquidity is rare and expensive. As a result, owners of options tend to do well.

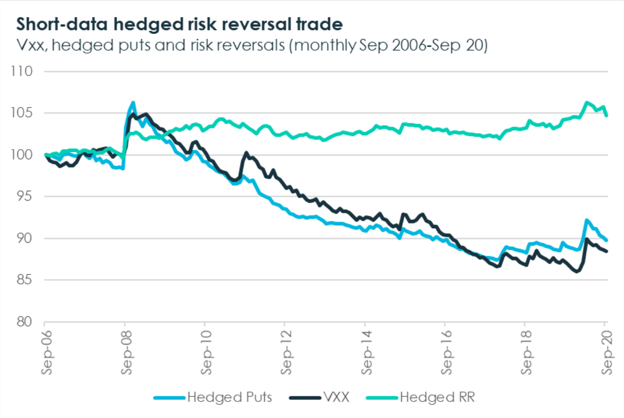
Options also offer their owners protection against jumps in prices.

Much of option theory assumes that asset prices trade continuously, without gaps. Portfolio insurance – the infamous hedging strategy that became popular in the 1980s – was, in fact, based on the idea that one could dynamically reduce exposure to risky assets as markets were falling. More recently, those investors either using trend following as a form of protection or investing in volatility-controlled products are making a similar assumption.

Reality can be different. Ask a market professional who tried to trade US equities on 19 October 1987; Lehman Brothers stock on 15 September 2008; or the Swiss franc on 15 January 2015. Asset prices can jump and options are one of the few instruments that give their holder protection.

How valuable was it to have owned a put option on the broad US stock market on 16 March 2020 when the sell-off accelerated into the close? The put option acted like an automatic stabiliser as the market dropped.

Option prices surge when volatility increases, and volatility can wreak havoc on portfolios. Of course, options are not a panacea for all portfolio issues. Options are not free and the cost frequently exceeds the benefits. Option sellers need a healthy compensation to protect themselves against liquidity and gap risk.



Source: Capstone, Bloomberg

Compare the implied volatility of options, a good proxy for premium, with the delivered volatility – a crude measure of the magnitude of gains from hedging a long option position.

From 1992 to 2020, the average of the VIX using end-of-month closing prices was 19.4. But the average of a similar measure of delivered volatility was only 15.6. Unless one had a crystal ball prior to pockets of market volatility, it would have been a loser to own options over time despite their benefits.

Consider the performance of the VXX – an exchange traded note with returns based on the S&P 500 VIX Short-Term Futures Index Total Return. While owning VXX or VIX futures that it tracks is not the same as actually owning options, VIX futures have an option-like characteristic: they spike in value when investors anticipate volatility. They are also easy for investors to access.

VXX has generated a positive return in 2007, 2008, 2018 and 2020 (so far). The average and median annual gain is nearly 100%. Unfortunately, in the other 11 years of the existence of it and its predecessor, the average annual loss has been 55% (median loss of 66%). Owning liquidity via VXX made sense so long as there was a meaningful volatility event every 18 months. Even today, that frequency is a stretch. Owning VXX over time has been, and likely will remain, a loser.

So how does the professional options trader, the skilled pilot, achieve the positive asymmetry of owning options while also mitigating their expense so they become viable and valuable portfolio tools?

The answer lies in the fact that not all options are equally expensive and some are sometimes even cheap. Professional options traders spend a lot of time looking for cheap options to buy and expensive options to sell. They care about the path and speed of the plane – assessing whether options prices are too low or too high given all the factors that are likely to move markets in relation to potential events

The owner of a strategy that buys one month 2.5% out-of-the-money hedged puts and simultaneously sells one month 2.5% out-of-the-money hedged calls – a 'risk reversal' trade – is generally a liquidity provider when markets drops and a liquidity demander as they rally. Owning such short-dated, hedged risk reversals has generated a small gain over time, while providing protection to downside moves in equities (see figure).

As this illustrates, carefully constructed options strategies can help diversify and protect portfolios without undue drag and even potential gains. To return to the plane, in conclusion to ensure a successful outcome and smooth flight, it is best to let the pilot plan the flight path and control the plane.

About the Author

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Jason Goldberg is a Senior Portfolio Manager responsible for managing dispersion and risk-transfer portfolios on the Solutions platform. Jason has been trading equity derivatives since 1998 and joined Capstone in 2018 from PIMCO where he was an Executive Vice President dedicated to equity dispersion. He also ran the equity execution desk for PIMCO and helped advise portfolio managers on equity-related strategies and trades. Before joining PIMCO, Jason was a Managing Director at Och-Ziff and a Partner at Onyx Capital. He started his career at J.P. Morgan and worked on both the equity derivatives and municipal derivatives desks.

Jason graduated magna cum laude and received a dual degree in Math and Economics from Claremont McKenna College.