Options to protect your portfolio

By **Stirling Larkin**

IN Australia, we often like to think of ourselves as behind the times, laggards, and regularly late to the party.

However, what few realise was that when it came to exchange traded and over-the-counter (OTC) options trading, along with Chicago in the US, Australia pioneered the way for this new category of investment product and early generation of hedging solution.

Shortly after Fisher Black, Robert Merton and Myron Scholes developed their Nobel prize-winning Black Scholes dynamic pricing model for options in 1973, the Chicago Board Options Exchange (CBOE) was founded that same year.

It was then soon followed by the world's second exchange traded options (ETO) market at the Sydney Stock Exchange in 1976. The Sydney Stock Exchange later amalgamated to become the Australian Stock Exchange (ASX) which then finally became the Australian Securities Exchange (also ASX) — which is the organisation we now recognise.

Today, in Australia, many investors and advisers alike often shudder at the phrase "options trading" and believe it only to be appropriate for ultra high net worth (UHNW) and institutional participants.

This is largely due to this product's categorisation as a derivative, which has also become a very dirty word.

With a "clearing of the baffles" post the GFC, options trading went from being considered an appropriate trading, investment and hedging solution for many investors to now being clearly considered persona non grata.

However, allowing the pendulum to swing so far back has arguably become unwise as there is a clear role for option and derivative products to play throughout the investment mix, here in Australia.

This is not to suggest that all investors should start trading options, but it is a category of market participation that should be better explored by more investment communities.

Options trading and related strategies can play a critical role in the success, profitability and downside protection of either an entire portfolio, a sector within it or even a single asset position.

Australian and international UHNW investors, who still incorporate options overlays throughout their portfolio solutions, recognise that options trading is not what's sometimes referred to as a zero-sum game; where for someone to win, someone else has to lose.

Employing an options overlay strategy to protect an existing portfolio — whether that be equities, property trusts, currency baskets, commodities or any number of underlying assets — is akin to taking out home and contents insurance over your household.

Many investors would not imagine, for instance, buying a house without such insurance and yet these same investors lie in bed concerned and conscious of the fact their share and investments portfolios may not be protected from a sudden downturn in markets.

With successive years of markets growth, many investors are keenly seeking ways of protecting their gains and portfolios from such a scenario.

The cost and pricing of these products which champions the Black Scholes pricing model factors in different market-sensitive attributes which help determine their value.

One such attribute is what is referred to as "implied volatility" and it is well recognised that, currently, implied volatilities and the cost of "put" options — which protect a portfolio's downside — appear cheap compared to historical pricing.

However, a term that is referred to as "skew", which in essence compares current prices to an assets return profile, currently, indicates that this downside protection through put options, in the US S&P 500 market, is already at expensive levels.

As our market is strongly correlated to the S&P 500, this observation then becomes important for us to consider Down Under.

The skew in European markets, currently, is much lower than in the US, which then means that downside protection on the Euro Stoxx 50, for instance, is better value than the American S&P 500.

Also, shorter-dated skew, over the next three months, is much higher than current 12 months levels. This is worrying because this indicates that the market is more concerned about a correction in the near term, both in Europe, America and then subsequently Australia.

Such flags may not eventuate or be correct over time but they are important for us to observe, interpret and respect.

Australian UHNW investors have re-energised their interest in downside protection put options over both the ASX 200 index and single-asset positions.

This protection affords the holder the right but not the obligation to sell the underlying asset or index for an agreed price on or before a specified date.

These can then be rolled into perpetuity, if desired.

This downside protection strategy can be especially prudent when an investor is sitting on large gains and wants them protected and this is reflective of the current market's performance.

This strategy protects a multi-asset portfolio from a potential fall in value and is often referred to as "hedging"; an investment that reduces or cancels out the risk in another investment.

As the option contract increases in value, the underlying asset price declines.

The advantage of holding options in a portfolio, in this way, is that they can offer protection when markets fall and provide exposure when things are on the upturn, through the use of "call" options.

Australian UHNW's have found this particular strategy additionally attractive because they not only retain exposure to the sharemarket and capital growth potential but they also pay no capital gains tax (CGT) on their shares as there is no disposal of assets.

It is also considered relatively nimble in that different exercise prices can be chosen that allow the investor to select the level of protection and cost. This means, the greater the protection, the greater the cost and vice versa.

No doubt the GFC odyssey took a lot of the shine off products that were previously considered flash.

Also, misuse of them by a small few, damaged their image for all.

But such trials and tribulations are a part of life and investing.

Upon sober reassessment, options for investing, trading and hedging should be strongly reconsidered by many, especially during this bizarre period of relative market tranquillity.

Adopting an open mind sounds like the best option.

Stirling Larkin is chief investment officer of Australian Standfirst
www.australianstandfirst.com