Australian Standfirst

Options Remain Open:

Defence, Protection & Risk Mitigation

Portfolio Management

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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 United States, Australia pioneered the way for this, then 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 advisors 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 products categorisation as a 'derivative'.

With a reset 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 now, 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, especially during turbulent times such as now.

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 equivalent 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 recognised that currently, implied volatilities and the cost of 'Put' Options – which protect a portfolio's downside – are not overly expensive given the magnitude of recent events.

However, a term which 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 expecting future dividends and distributions to continue but at discounted levels.

As our market is strongly 'correlated' to the S&P500, this observation then becomes important for us to consider in Australia.

The skew in European markets, currently, is arguably lower than in the US which then means that downside protection on the EuroStoxx50, 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 twelve months levels, as understandably we continue forward into the current *known unknown*.

This is worrying because this indicates that the market is more concerned about a correction in the near term, both in Europe, American 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 reenergised their interest in downside protection 'Put' Options over both the ASX200 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 wants to protect an existing portfolio during a volatile environment such as currently seen.

This strategy protects a multi-asset portfolio from a potential fall in value and this 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 which 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 serious reassessment, Options for investing, trading and hedging should be strongly reconsidered by many, especially during this bizarre period of relative market volitility.