Know What You Own: Options Alpha Strategies

Understanding the Diversity of Options Strategies

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Morningstar added a much needed Options-Based Fund category, but labelling all the different options strategies into one single category can be misleading. Further distinction is necessary for advisors and investors to gain a better understanding of the options strategies they're considering or managing expectations for the funds they are already incorporating into their plans.

We break down the category into three subcategories:

1. Hedging Strategies
2. Income strategies
3. Alpha/trading strategies

We have already covered hedging and income strategies, so in this post, we focus on alpha/trading strategies, their primary objectives, variations, when they work, and their risks.

Options-Based Alpha/Trading Strategies

The goal of alpha or trading strategies is to generate returns primarily, if not solely, through the trading of options. The role that a core, long holding plays in the overall returns is secondary. In fact, there might not even be a core holding in an alpha strategy. It could be that the core holding is cash or cash equivalents, maybe with a few futures mixed in for some market exposure. Suffice to say, an alpha strategy will live or die based on the strength of its trading program.

Some strategies position themselves as being market-neutral, while others as dynamic or tactical. While it might be naïve to think the market does not impact their returns, the implication is that the return stream generated by such strategies have low correlations and betas to traditional portfolios.

Variations on the Theme

There is an unlimited number of ways a trader can buy and write calls, puts, strike prices and expiration dates to create different risk-reward outcomes. Sometimes different combinations of options might create very similar risk-return profiles. Conversely, a seemingly small change to a single position in a multi-part can potentially have a dramatic impact on the risk-return profile of another trade. All of these possibilities are on the table for the alpha/trading strategy.

When It Works

Of the three primary types of options strategies so far, alpha strategies are the most difficult to predict. After all, if a hedging strategy is truly hedged, it is reasonable to expect it will do well in down markets and lag in up markets. But an alpha strategy can be all over the board. Options can create about any profit/loss scenario available, so any of these trades might be in use with an alpha strategy.

In addition, alpha strategies can be tactical with the types of trades they put on. It is unlikely that they will stick with one type of trade throughout any environment. One week they might be doing vertical spreads, the next week they might be trading long butterflies. In some cases, such as strategies solely focused on iron condors, the risk profile will look similar to a hedged strategy (collar).

What this amounts to is a highly active, hard to predict strategy. An investor who invests in an alpha strategy is placing a high degree of trust in the skills of a portfolio manager because it is unlikely that the investor will have much visibility into the day-to-day operations of an alpha/trading strategy.

Possible Risks and Drawbacks

Alpha strategies can often be described with the old adage, “live by the sword, die by the sword.” It is true that some alpha strategies do a remarkable job of providing outsized returns. Sometimes these strategies might enjoy a stretch of years without a significant downturn. However, when a particular strategy falls out of favor, the reversals can be quite harsh.

It is very difficult to anticipate how an alpha trading strategy might perform in a bear market. They could do spectacularly well, they could blow up, or they could fall somewhere in-between. That said, the Achilles Heels of many alpha trading strategies are volatility spikes, leverage risks, and liquidity risks.

Sometimes alpha strategies employ leverage to “juice” their returns. If there is no underlying, long holding to help drive the returns of the strategy, alpha strategies will have to generate most or all of their returns from the option trading program. Because the profit potential of any short options position is at most the premium collected, the temptation exists to engage in larger trades. This can create leverage. If things go right, leverage will amplify the gains. However, if things go wrong, the ill impact of leverage can quickly snowball. This is especially true given the asymmetric risk/return parameters of options.

These risks tend to increase in a market sell-off. Many alpha trading strategies are better suited for calmer markets rather than choppy ones.

Conclusion

There is an old saying by the Swiss physician Paracelsus, “All things are poison, nothing is without poison, the dosage alone makes it so a thing is not a poison.” One could easily repurpose this statement to investing- “All investments have risk, nothing is without risk, the allocation alone makes it so an investment is not a risk.”

By pointing out the risks of alpha/trading strategies, we are not issuing a blanket rejection of all alpha strategies. There might well be a role for such highly idiosyncratic managers to complement a plain-vanilla portfolio. What we would caution, however, is that it is very difficult to “know what you own” when it comes to alpha/trading strategies, and therefore the prudent thing would be to use them as non-core, satellite holdings.

About the Author:

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