SWAN GLOBAL INVESTMENTS

Know What You Own: Options Hedging Strategies

Understanding the Diversity of Options Strategies

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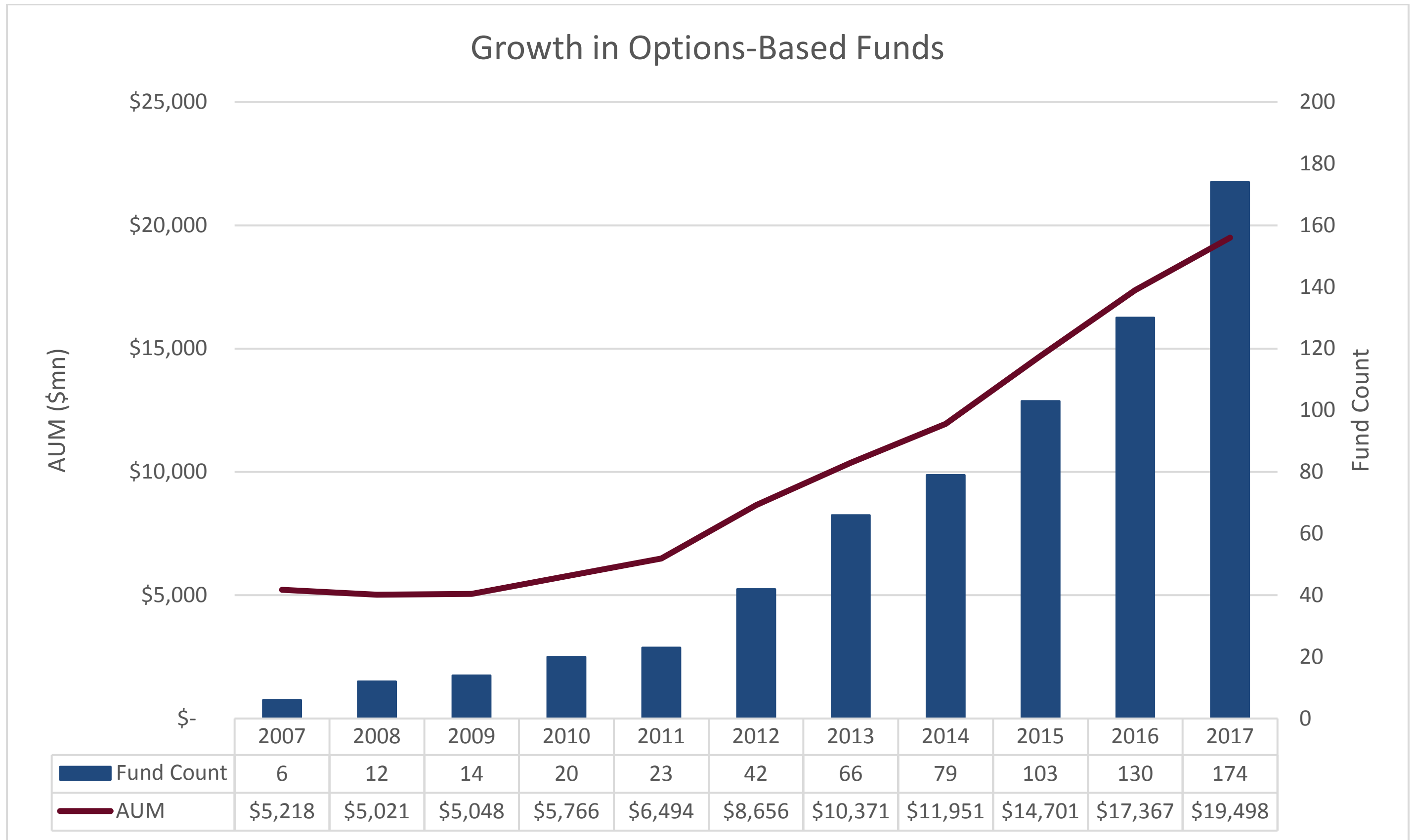
Options-based strategies have seen a lot of recent growth in both assets under management and number of products available.



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Fund Count	6	12	14	20	23	42	66	79	103	130	174
AUM	$5,218	$5,021	$5,048	$5,766	$6,494	$8,656	$10,371	$11,951	$14,701	$17,367	$19,498

Source: Morningstar Direct

To keep pace with the growth of options-based strategies, Morningstar released a new category called "Options-Based" to encompass those mutual funds and ETFs that heavily use options.

The Morningstar Options-Based Category

Morningstar defines the Options-Based category as funds where options are a central component of their investments strategies and where trading options may introduce "asymmetric return properties to an equity investment portfolio." It goes further to list the variety of strategies: "put writing, covered call writing, option spread, options-based hedged-equity, and collar strategies."

While the addition of this category is certainly a step forward and a welcome development, we believe the category can be further divided into distinct sub-categories.

Three Subcategories of Options-Based Funds

The potential to mix and match different option positions and core holdings provides an almost limitless range of profit/loss scenarios, it helps to classify option strategies into one of three sub-categories, namely:

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

While no classification system is perfect, most option strategies will fall into one of these primary categories. But more importantly, these categories are defined by what the strategy is trying to achieve.

This post will discuss the options-based hedging strategy with future posts focusing on the other two.

Options-Based Hedging Strategies

Hedging strategies are defined as having a core, long portfolio but also taking active steps to hedge downside market risk via options. Investopedia defines a hedge as “an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security.” In our opinion, options are an ideal instrument for removing price risk from a portfolio.

It is important to note that many strategies include the term “hedge” in their name but might not be directly reducing market risk. For this subclassification, we are limiting our definition of hedging strategies to those that explicitly seek to offset market risk.

Variations within the Category

Within this category, there may be variability since there are many ways to implement a hedging strategy. Some elements that can affect each strategy are:

- the inclusion of additional trades to offset the hedging cost
- where the levels of hedge protection are set
- the amount spent on hedging
- time to expiration of the hedges used
- if the strategy is always hedged or on a “risk-on/risk-off” approach

These variables will undoubtedly lead to a dispersion of results within the sub-category. For example, of the 38% that could be quantified as hedged equity (24 funds), only six funds appear to utilize puts expiring between 120 days and 365 days out, while four funds (all Swan) use puts expiring greater than 365 days out. Fourteen funds utilize shorter-term hedging of less than 120 days and six funds use put spreads to hedge (limited protection).

The time to expiration and type of hedge will have a great impact on how each of these funds will perform during a bear market. If the bear market extends beyond 120 days, most could run into a very cost prohibitive hedging environment.

When It Works

Hedging strategies do best when markets sell off. After all, that is what hedging is designed to do. Generally speaking, the bigger the sell-off, the more valuable the hedges become. Given the fact that correlations tend to spike across most asset classes and strategies during a true market rout, direct, explicit hedging is one of the best ways to offset market risk.

Possible Risks and Drawbacks

Lag in an Upward Market

The drawback to a hedging strategy is that it will likely lag in an upward market. If the hedge is expected to rise in value if the market falls, then it stands to reason the hedge should fall in value if the market rises. This can cause investors to view the hedge as a "cost" during upward markets.

Price Paid for the Hedge

Another risk to hedging strategies is the price paid for the hedge. The price of hedging is driven by supply and demand. During times of complacency, hedging can be cheap. However, when markets start selling off and investors panic, the price of hedging can skyrocket. A good hedging strategy should anticipate the price of hedging will increase when hedging is most needed and have a plan to accommodate that outcome.

Counterparty Risk

If one owns a hedge that is designed to pay off handsomely if the value of an asset falls, one should be sure that the counterparty in the agreement is in a position to pay. This risk was realized during the Global Financial Crisis, when some hedges were endangered by the counterparty's inability to meet their contractual obligations. Since the GFC, there has a been a big push for hedging and derivative contracts to move to exchanges where the terms are standardized, and the backing is provided by clearinghouses.

Finding the Strategy that Fits

Options-based strategies can be quite diverse and one of the best ways to make sense of them is to identify their objectives, benefits, and risks. Each strategy has different objectives and risk/return characteristics and understanding this will help advisors and investors make better informed decisions about which strategies to include in their financial plans.

In the next two posts, I will dive deeper into income strategies and alpha/trading strategies.

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Client Portfolio Manager, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly, Marc was the Director of Research at Zephyr Associates for 11 years.

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