Lack of Liquidity in Options-Based Strategies

Evaluating Options Strategies, Part 2

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Options strategies are versatile tools to include in a portfolio, so discounting all options strategies as dangerous and risky because of a few blow ups can be limiting. Examining these blow ups reveal some common areas that advisors can evaluate for when choosing an options strategy.

The three areas where options-strategies get into trouble are leverage, liquidity, and risk controls. In a previous post, we explored the danger excessive leverage can pose to an options-based strategy. In this post we discuss the second of three "smoking guns": the risks of investing in thinly traded, illiquid options.

Trading Volume and Liquidity Risks

Options are just like stocks or bonds in the sense that the liquidity experience can be entirely different depending upon the security. Typically, no one has any problems trading Apple stock or on-the-run U.S. Treasury bonds. However, the bid-ask spreads on a microcap stock or a small-issue, high yield bond can be significant. The same dynamic is true in options.

The table below shows the top five exchange traded options in terms of volume on a randomly selected date (12/14/18). In these instruments, billions of dollars can be traded without any discernible impact on price.

VOLUME (12/14/18)	UNDERLYING	DESCRIPTION
7,749,626	SPY	S&P 500
1,957,012	QQQ	Nasdaq
1,107,952	EEM	Emerging Markets
277,860	HYG	High Yield Bonds
215,370	EFA	Foreign Developed

Source: Cboe

On the other hand, options on more obscure underlying assets can be thinly traded and have wide bid-ask spreads. While the profit margin may be bigger, there is a greater liquidity risk when trading these types of securities. Investors who dabble in this space obviously think it is worth it. Just like microcap stocks or high yield bonds, profit opportunities sometimes exist in the less efficient corners of the market.

Looking at recent average daily volume, provided by the Cboe, the vast majority of option volume resides in just a few names. In fact, the top 1% of single stocks that trade options account for approximately 45% of the average daily volume.

Top % of Names	ADV %
1%	45%
2%	56%
5%	73%
10%	85%

Source: Cboe

If the top 10% of options account for 85% of the average daily trading volume, that means that 90% of the listed options account for only 15% of the average daily volume. Your typical trader is going to be forced to pay more to trade in this long tail of the options market.

However, the problem with liquidity is that it tends to evaporate when you need it most. Even options on some of the most liquid securities, like the SPDR ETF, can see wider bid-ask spreads during large market moves. In periods of market panics or sell-offs, trading in already illiquid securities can grind to a standstill.

Pricing assumptions sourced from normal markets might fail to anticipate just how wide bid-ask spreads can be in a panic, thus dramatically increasing the tail risk in a crisis.

Evaluating Liquidity Risks of an Options Strategy

Understanding how liquidity can affect an option strategy is important in setting expectations and understanding the risks. Some questions one might ask are:

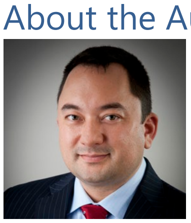
- What options does the strategy typically utilize?
- Is the strategy long or short the options?
- What is the average daily trading volume on the options traded?
- What are the high/low ranges in volumes on the options traded?
- What is the typical bid-ask spread on the options you trade?
- What was the bid-ask spread during times of crisis, like the February 2018 “volmageddon” spike or the August 2015 sell-off?
- What is the “worst-case scenario”?

Compounding the Problem

Illiquidity tends to mix poorly with leverage and can rupture a strategy’s risk controls. High leverage might force a manager to close out his position right at the time when pricing is at its most unfavorable, compounding losses.

Our next post in the series will cover risk controls and why failing to adhere to them can result in detrimental consequences.

About the Author



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