OPTIONS-BASED STRATEGIES DUE DILIGENCE GUIDE

Tips for Evaluating Options-Based Investment Managers

EVALUATING OPTIONS-BASED STRATEGIES

Options-based strategies come in various shapes and sizes; they have different objectives, processes, and risks. Investment manager due diligence can be complex for these strategies, and asking the wrong questions can lead to misunderstandings and unsuitable recommendations for your clients.

Like any other manager due diligence, it is more than simply analyzing investment returns. You will want to use your usual due diligence approach in uncovering how results were achieved, but even more important with these strategies is focusing on what the risks are, how the investment strategy aligns with your client's risk tolerance and objectives, and the investment's consistency in delivering returns.

This guide will help you identify the right options-based strategy for your client(s) and equip you with the questions you should be asking for each type of strategy.

Investment management due diligence can be easier and faster with the right questions and foundation.

EVALUATING HEDGING STRATEGIES

Hedging options-based strategies have a core, long portfolio with active steps to hedge downside market risk with options. These strategies seek to directly mitigate and offset market risk. Some hedging strategies may have the name but a different objective: to produce uncorrelated returns or minimize volatility. Be sure to identify the objective clearly before delving deeper into the due diligence process.

Objective

- Risk managament
- Downside protection

Basic Structure

- Long position in market
- Long puts to protect on downside
- Possibly some trades to subsidize the cost

When It Works

A well designed, direct hedging strategy does the best when markets sell off. The bigger the sell-off the more valuable the hedge becomes.

Risks/When It Doesn't Work

- Cost of hedge will be a drag in up markets
- Price of hedging goes up in times of panic
- Counterparty risk
- Basis risk

Due Diligence Questions for Hedging Strategies

- What is the cost of the hedge in up markets?
- What level of protection is there in down markets?
- Are the hedges typically ATM or OTM?
- What percentage of the notional value is typically hedged?
- Is the strategy risk-on/risk-off with the hedging?
- Are there other trades that can offset the hedge?
- Are the hedges exchange traded or over-the-counter?
- Is there basis risk?

EVALUATING INCOME STRATEGIES

Income strategies have long holdings at the core of their portfolio and seek to supplement returns with option trades. These trades typically involve systematic writing of short-term calls and/or puts.

Objective

- Income
- Supplemental returns

Basic Structure

- Long position in market or cash
- Writing of calls and/or puts

When It Works

- A gently rising market
- A range-bound market
- A flat market

Risks/When It Doesn't Work

- When realized volatility exceeds implied volatility
- When markets sell off significantly, as there is no hedge
- Whipsaw market environments
- Leverage can be a risk
- When markets get close to or go through strike price of written options

Due Diligence Questions for Income Strategies

- What kind of trades do you engage in?
- Is there a directional component to the trade?
- How leveraged are the trades?
- How liquid are the trades?
- Are the trades actively managed?
- What are the expectations under various sell-offs and volatility spike scenarios?
- Are the options written American or European style?

EVALUATING ALPHA STRATEGIES

Alpha options-based strategies seek to generate a positive return stream largely independent of market movements. The primary goals is to generate returns so it may not have a core long holding. While many position themselves as market-neutral, others may be tactical or dynamic.

Objective

- Generate returns

Basic Structure

- Can be just about anything
- Typically no core equity holding
- Tend to write calls and/or puts
- Usually tactical
- Can be leveraged

When It Works

- Typically does well in more benign markets
- Depends upon skill (or luck) of portfolio manager

Risks/When It Doesn't Work

- Tend to do poorly during volatility spikes
- Leverage can be a major risk
- Liquidity of options traded can be a big risk
- Sometimes poor visibility into the trades & difficult to predict

Due Diligence Questions for Alpha Strategies

- What kind of trades do you engage in?
- In what environments will the strategy work or not work?
- How leveraged are the trades?
- How liquid are the trades?
- What are the "Greeks" and how are they managed?
- What are the expectations under various sell-offs and volatility spike scenarios?

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