Suitable for wholesale/sophisticated investors

Using options to improve risk and return

In this note we introduce options, outline their key characteristics and discuss how they can be used to **increase returns and reduce risk**.

Options 101

An option is a financial instrument that gives the owner the right, but not the obligation, to buy or sell an underlying asset for a pre-agreed price on, or by, a certain date in the future.

For example, consider an investor that owns a share that is currently worth $100 but is worried that the price could fall. The investor could buy an option that gives them the ability to sell the share for $100 at an agreed time in the future. If the share declines in value the investor can 'exercise' the option on the 'expiry date' and sell the share for $100.

In this way, investors can buy options to transfer a market-related risk they do not want to the option seller, just like individuals can buy insurance (e.g. house, car or health insurance) to transfer the risk of financial loss from certain events to the insurance company.

Option sellers take on this risk for a price and, like insurance companies, the price they charge tends to include an amount to cover the risk plus an expected profit margin.

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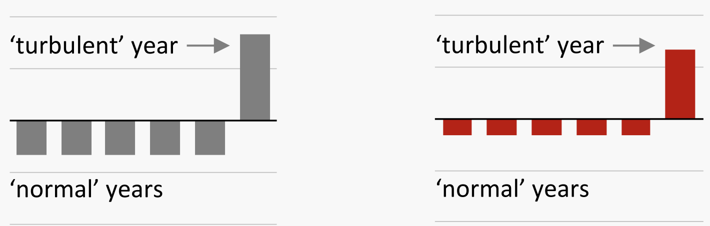
because of the risk-transfer nature of options and the profit margin built into their price, option sellers expect to make a profit over time

Using options to provide cost-effective protection

The investor who buys an option for protection should receive a benefit in 'turbulent' markets but incur a cost in 'normal' times. Because of the profit margin in option prices, they would expect to lose money over time (just like when they purchase other insurance).

The investor could go a step further and purchase a portfolio of options and use dynamic risk management to mitigate their expected cost. The aim would be to significantly reduce the cost in normal times while keeping most of the gains in turbulent market conditions.

Figure 1: Basic protection (left) with dynamic risk management (right)



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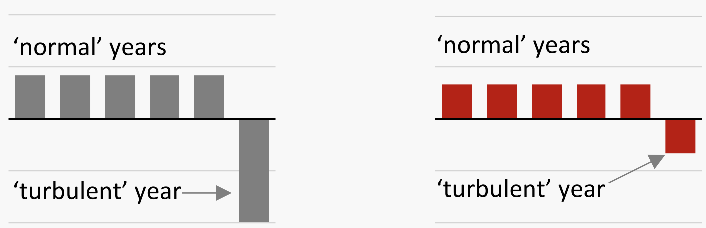
Using options to generate defensive alpha

An option seller receives a 'premium' for selling the option. If the option seller chooses not to manage the risk of the option, they would expect to make a profit in 'normal' market conditions but incur a loss in 'turbulent' market conditions if the payout on the option is more than the premium they received.

An option seller could instead manage the risk of the option, effectively paying away some of the premium to protect against large losses (like an insurer uses reinsurance). The aim would be to significantly reduce losses in turbulent market conditions while keeping most of the profit in normal times.

Figure 2: Basic option selling (left) with dynamic risk management (right)



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Adding option strategies to defensive or growth assets

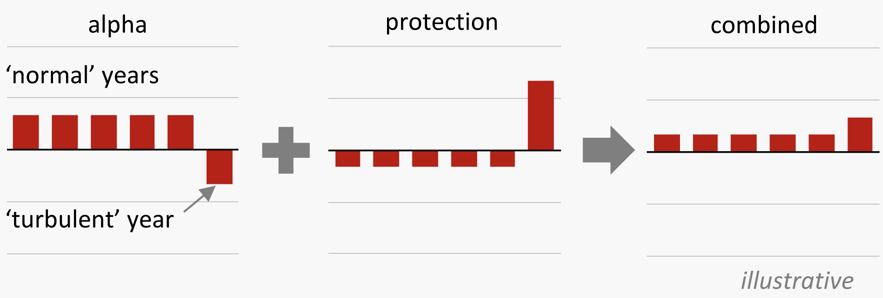
Many investors hold a large part of their assets in equities. It is prudent for investors close to, or in, retirement to reduce the risk of their portfolios. However, the traditional approach of moving from growth to defensive assets is a very blunt tool.

Defensive assets are expected to earn lower returns than growth assets. Many retirees live a long time, and moving too heavily into defensive assets too early could lower future returns. This increases the risk of running out of money or being forced to live more frugally than desired.

> *investors should look for ways to reduce risk without reducing expected returns*

In a portfolio context, investors should explore ways to increase the expected return of their defensive assets without increasing their risk, or decrease the risk of their growth assets without decreasing their expected return.

Figure 3: Combining defensive alpha with cost-effective protection



As Figure 3 illustrates, dynamic option strategies can be combined with the aim to generate positive returns in 'normal' markets and greater positive returns in 'turbulent' markets. This return profile can be added to traditional assets to try to reduce risk and increase expected returns.

For example, adding dynamic option strategies to cash can create an investment that aims to deliver defensive asset diversification with higher returns than traditional defensive assets.

Alternatively, adding dynamic option strategies to equities can create a potentially lower risk growth investment that aims to outperform equities in 'normal' years and outperform by more in 'turbulent' market conditions.

These approaches may provide investors with better long-term returns by aiming to increase returns while decreasing drawdowns, providing lower sequencing risk and greater compounding benefits.

Further reading

For a deep dive into using dynamic option strategies to create defensive alpha and cost-effective protection, including examples of adding these strategies to cash or equities, see our paper 'Volatility for alpha and protection'.

For further discussion of how dynamic option strategies can be used in portfolio construction to reduce risk and increase returns see our paper 'Volatility and portfolio construction'.

Important information

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About SouthPeak

SouthPeak is a specialist volatility manager providing alpha and protection.

We aim to deliver attractive outperformance with low correlation to bonds and equities.