

INSTITUTIONAL INVESTORS SEEK GREATER RETURNS THROUGH OPTIONS-BASED STRATEGIES

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As institutional investors continue to seek ways to improve their investment returns, many have moved from core equity and fixed income strategies to more esoteric classes, such as alternative assets. In the last few years, a newer trend has emerged: employing an options-based strategy to attain equity-like returns on a risk-adjusted basis.

Because pension plans are newer to adopting options-based strategies, there is a learning curve to overcome and important points to consider. For example, the differences between listed options (i.e., options that are listed on an exchange) and OTC options (i.e., options that are not listed on an exchange, but trade over-the-counter) can impact the decision to utilize one over the other. Listed options may offer better liquidity, price discovery and transparency, whereas trading in the OTC market, may provide access to more exotic options that are not listed on any exchange. OTC options may also provide greater flexibility than traditional listed options because there is no standardization of strike prices and expiration dates, allowing participants to negotiate customized terms. A newer type of listed option, called FLEX options (short for flexible exchange options), offers customization of contract terms (like OTC options) but (unlike traditional listed options) does not have a continuous quote stream. As investors look to move out of commingled vehicles into self-managed accounts with customized strategies, exchange-listed options and FLEX options can be attractive because they offer price discovery and transparency. Because they are OCC cleared contracts, they may also provide lower counterparty risk and regulatory complexity.

Leveraging exchange listed options provides:

- 1) Portfolio protection, particularly following a long bull market;
- 2) Increased income/yield from long stock holdings;
- 3) Improved overall risk-return profile.

When embarking upon a strategy that leverages exchange listed options, the investor will want to do their due diligence. It is important to understand market structure, how the products trade, where they trade, and how they are valued. A crucial decision is selecting the right broker. In options trading, a broker is a key investing partner. What are some factors to consider for an institutional investor when selecting a brokerage partner?

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Finding a broker that offers expertise and scale, flexibility, and the most efficient systems and processes will ease the transition to options trading.

A partner with significant expertise and scale should translate to better overall returns, quality execution and competitive pricing. An experienced provider understands the options market, is well-versed in margin and collateral optimization, can provide guidance on strategy and implementation, generate ideas, and identify cross-market concepts and trends. A broker with experience in global markets can educate investors on geopolitical and economic factors that affect investment strategies and can outline the risks and benefits of various transactions.

Another important consideration is flexibility. Does the counterparty offer support across multiple structures and relationship types? Can they build custom models around risk appetite, trading objectives and market perspective? Finding a provider that understands what drives an institutional investor, what they hope to achieve with options-based investing, and creating the right portfolio based on those drivers will offer the best outcome.

Finally, the right partner will have efficient systems and processes in place. A straight-through processing environment can increase efficiency, reduce errors and improve speed. A provider with connectivity to client systems can improve the quality of data transmission, resulting in better information exchange. Automated reconciliation feeds reduce the incidence of trade breaks and post-trade reporting and analytics can give the investor transparency into their accounts. For example, extensive pre- and post-trade analysis allows investors to confirm the quality of executions. Also important is the ability to shadow-reflect activity with the custodian. This is crucial to ensure that margin requirements are being met and that collateral movement and trade settlement are being properly handled.

Institutional investors are increasingly recognizing the advantages of implementing listed options as an investment that can help improve the risk-adjusted return profile of their portfolios. Finding the right brokerage partner, one that offers scale, expertise, flexibility and efficiency, can make it easier to employ these strategies.

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