Options Newsletter for Investment Advisors

TMX Montréal Exchange

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Update to the "A 10-Year Comparison of Options Users" Study

In our last issue, we presented the Options Industry Council's study[1] showing that options investors represent a market of choice for investment advisors. They use more financial products and trade more often yearly compared to investors not using options.

The study is conducted every five years, the last update[2] being in April. New data confirms previous results that options users trade stocks more often than non-users of options, executing on average 31 trades per year (24 trades for non-users). The 2010 study also confirms that options users are wealthier as 49% have an income over US$100,000 per year (43% for non-users) and 31% have liquid assets over US$500,000 (29% for non-users).

Download PDF of study (466k – 56 pages)

Talking Options with your Clients – The Right Way

An interesting finding in the 2010 "A 15-Year Comparison of Options Investors" study is that among investors who have never traded options, the lack of knowledge is cited as the primary reason for not trading options. Encouragingly, 50% have expressed their desire to trade options in the future, opening the door to additional growth in options business.

Talking options to your clients can be difficult. In fact, explaining unfamiliar concepts in layman's terms is not easy. Your clients are most likely familiar with stock investing as they are certainly already accustomed to trading shares. Therefore, your objective should be focused on explaining to clients how to use options as a risk management tool that replicates stock investing.

Let's start with what to avoid

There is one approach to avoid and that it is the use of options as a speculative tool. Not that speculation is bad, but because the level of knowledge required to succeed is very high and there is no guarantee of success. Using leverage can provide huge rewards. However, leverage is a double-edged sword, and we should be careful with which side we use as the consequences

[1] *A 10-Year Comparison of Options Users*, Harris Interactive Inc., available at http://888options.com/press/files/harris_study_2005.pdf

[2] *A 15-Year Comparison of Options Investors*, Harris Interactive Inc., available at http://www.optionseducation.org/press/files/harris_study_2010.pdf

could be disastrous. When talking options to your clients, the most important point is to not introduce new unfamiliar risks in your clients' trading environment. The last thing you want to introduce to your clients is highly technical options talk; for example, "an unexpected loss occurred following a change in the option's vega, which caused the delta to fluctuate dramatically because of the strong gamma of the option". Let the experts talk this way.

Familiar risks

A typical investor is already familiar with two types of risk: 1) the risk of loss that comes from holding shares and 2) the risk of seeing the stock price increase after selling the shares. Keeping the focus on options strategies that address these familiar risks reduces the potential of unpleasant surprises.

It is essential to introduce options as a risk management tool that can complement your client's investment strategy, and not as a miraculous financial product that will eliminate the inherent deficiencies of the strategy. Using options cannot compensate for a bad selection of securities. That's why, if a stock price goes down, one should not blame the loss on the fact that options were used. Selecting the right stock is the core of the investment strategy and using options serves only to acquire the shares subsequently. In this context, the use of options is very safe. The same holds true for selling a stock. We all know how difficult it is to time perfectly the sale of a stock when the market is rallying. The investor must base his decision on a rigorous analysis. Again, it is the investor's decision to sell the shares and using options serves only to sell them subsequently.

Once the decision to buy is made, it is time to execute the strategy. If you like the current market price, then buy the stock right away. However, if you think that the price of the stock is too high and would like to buy at a lower price, you should consider using options. Thus, instead of placing a good till cancelled order at the target price, you could sell a put option with a strike price equal to your target price. The premium received from selling the put reduces your purchase price, which makes this strategy a better alternative to buying the stock in the market. If the stock price is above the strike price at expiry, you will not buy the stock. Same as if the stock price remains above the price at which you would have placed the good until cancelled order. The only difference is that the investor will keep the option premium. It's like getting paid to buy shares.

Now that you own the shares, you have to develop a selling strategy. When and at which price are you willing to sell them? Once the decision is made, you can sell them directly in the market if the price is right. However, if you want to sell at a price higher than the market price, you can place a good till cancelled order at your target price or wait for the market to reach your target price before placing the order. In both cases, selling call options on the shares that you own (covered call writing) allows you to receive a premium for taking on the obligation to sell them at the chosen strike price. This premium guarantees that you will receive a better sale price with options, compared to selling the shares directly in the market. At expiry, if the stock price is lower than the strike price, you will not sell your stock and you could sell another call option to cash in another premium. Or, you may decide to sell your stock directly in the market as well.

These two options strategies are an excellent alternative to buy or to sell a stock at a price better than doing so directly in the market. When selling put options, the stock purchase price is reduced by the premium received and when selling calls, the stock sale price is increased by the premium received. Implementing these two strategies does not expose your clients to new unfamiliar risks. The sale of puts (as the purchase of shares) implies a risk of loss if the price of the stock drops, while the sale of calls (as the sale of shares) implies the risk of seeing the price of the stock rise subsequently. In both cases, resulting losses (or shortfalls) should not be attributed to the use of options since the decision to buy or to sell is a result of the investor's stock analysis.

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In this context, the use of options is a very interesting complimentary tool. This method allows investors to learn about options at their own pace without fearing to be adversely impacted by the different factors affecting the price of options.

Another case where you don't need to be an expert to use options is when you want to protect a sale price in anticipation of a future sale, or a purchase price in order to buy shares at a future date.

This option strategy is similar to buying insurance and is not considered speculating on the price direction. The investor must understand that the premium paid is equivalent to a car or house insurance premium. At the end of the year, you will not see insured persons being upset about the fact that they paid a premium for no reason. Same for options users. In fact, it's a good thing that put options are not exercised; it provides an opportunity to sell the shares at a price higher than the strike price. Same for call options that are not exercised; it provides the investor with an opportunity to buy the shares at a price lower than the strike price. In both cases, the worst scenario results in having to sell or buy the stock at the strike price (the insurance price) while the investor still has the possibility to execute the trade (the purchase or sale) directly in the market at a better price.

In the end, you should view the development of your options business with a long-term approach. Even if the possibility to realize tremendous gains could attract a certain type of clients, you should not introduce the speculative element in your game plan with new options users.

When used to implement investment strategies, or as insurance, options become a very useful tool for buying or selling stock at a better price. New options users can therefore learn to use options in a safe and positive context.

Options Training Seminars offered by the Montréal Exchange

The Montréal Exchange can organize options seminars using the approach described herein for your clients. To book a seminar, contact Mr. Stoil Popov, Director, Business Development, by email at spopov@m-x.ca or by phone at 514 871-7898.

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