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What Options do Investors have?

"Is the current lack of volatility and directionless trading a forecast that history may be about to repeat itself?."

Mark Munro discusses the potential use of derivatives.

Investors disappointed with the equity markets lack of progress so far this year should perhaps take a look at historical performance over the past one hundred years. In the twentieth century there were three extended periods when investors achieved flat returns, as measured by the Dow Jones Industrial Average. The most recent period was 1966-1982 during which the real return to investors averaged -0.5%pa. The Japanese market is another example with the Nikkei 225 currently trading at levels seen back in 1984.

Is the current lack of volatility and directionless trading a forecast that history may be about to repeat itself? If so, how can investors protect themselves, and even profit, from such a low return scenario?

We believe that in such markets the use of derivatives and in particular traded options may well be a means of achieving out-performance. These securities have been around for hundreds of years, indeed the ancient Greeks and Romans are reported to have used them. However it is only in the past twenty years or so that they have been considered as mainstream investment vehicles.

Basically there are two types of option - calls and puts. The buyer of a call/put option has bought the right (but not the obligation) to buy/sell a fixed number of shares within a given time period at a pre-determined price (the excercise price). Investors blessed with the ability to accurately predict future price movements on a consistent basis can generate enormous profits through the timely purchase of call and put options.

However the overwhelming majority of investors (ourselves included) do not possess such wisdom and in such cases selling covered options (where the underlying shares are held in the case of calls and sufficient cash is held in the case of puts) can substantially enhance returns in a directionless market. An investor holding substantial levels of cash can sell put options in stocks that he would like to own at an exercise price that he finds attractive; should the option be exercised (and the stock purchased) then his objective will have been met along with the receipt of premium from the option sale. Likewise an investor who holds a portfolio of shares can enhance his return by selling call options against his holdings. Of course he must be prepared to sell the shares if exercised and as such careful selection of the exercise price is required.

Every sale generates a premium which can be used to reduce the book cost of the underlying security. In effect the option writer is being paid for leaving limit orders in the market without being unduly influenced by sentiment.

Such strategies are not an alternative to holding shares but can be used to improve the return on a conventional portfolio. Contrary to popular perception covered option writing is an extremely conservative strategy.

Needless to say investors expecting the new bull market to arrive imminently should disregard the above!

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