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How to Increase your Book Using Options

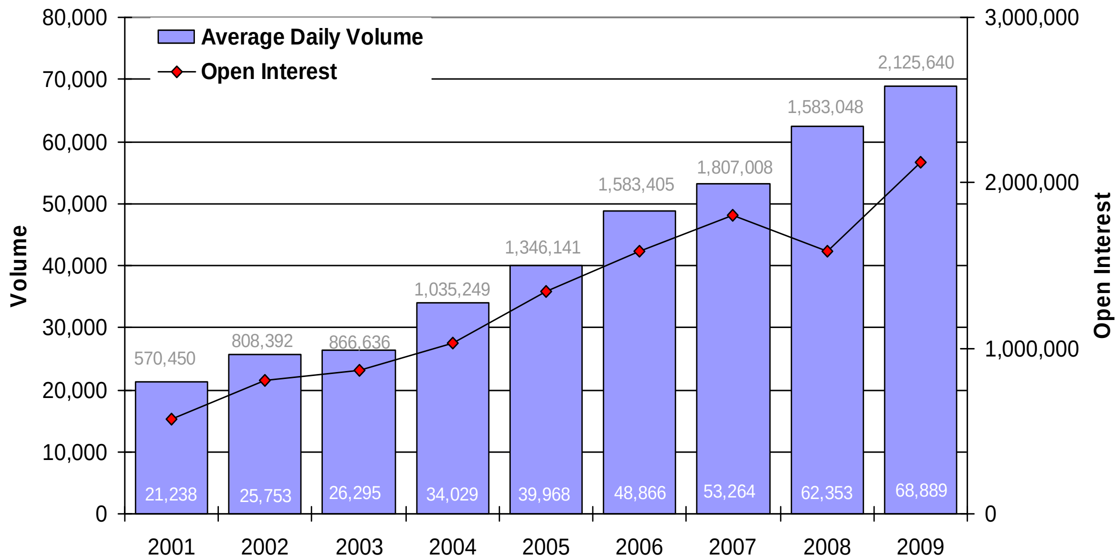
During the last two years, large swings in the stock market have taught us the importance of integrating a sound risk management policy in our investment plans. After making a new record high in 2007, stock markets have registered their second 50% drop over the last ten years. Wouldn’t have been nice to keep an important part of the gains we had realized until then? Here we are now, one year after the March 09 bottom, having regained more than 60% of what was lost. Will this trend continue to new highs or will we see a substantial correction that could lead to a retest of the bottom? No one knows for sure.

Even if we can reduce, or even eliminate, the specific risk of a security by diversifying our holdings, market risk cannot be eliminated through portfolio diversification. It’s good to know there are tools that allow adjusting this risk to a comfortable tolerance level. It is possible to use options in such a fashion that we can preserve the profit of a position while being able to profit from further moves on the upside. Put options give the holder the right to sell at a floor price if the price of the underlying shares falls. They act as insurance for the holder who can claim losses resulting from stock price drops.

Options offer even more possibilities. They can be used to secure the purchase price of a security while, for example, waiting for a bond to mature. We can also buy or sell stocks at a better price and take advantage of price fluctuations in such shares.

The following chart illustrates how popular options have become over the last nine years. The growth in equity and exchange-traded funds (ETF) options traded on the Montréal Exchange has reached an annual rate of 16% since 2001. The 2009 average daily volume of 69,000 contracts represents a 10% increase over 2008. The most impressive statistic is the open interest which has established a new record in 2009 with 2.1 million contracts, an increase of 34% over 2008.

OPTIONS ON EQUITIES AND ETFs
AVERAGE DAILY VOLUME AND OPEN INTEREST



As we can see, the options market offers a huge business potential. A study[1] published in the USA[2] by the Options Industry Council (OIC) indicates that investors using options should be highly considered for expanding your business as they use more financial products of any kind and they trade more often during one year than those who don't use options. In fact, four times as many options investors make more than 50 trades in one year than those who don't use options. Furthermore, 41% of options users were earning more than US$100,000 as opposed to 28% for non-users, while 32% of options users had liquid assets exceeding US$500,000 as opposed to 17% for non-users. Last, the study shows that options users tend to rely more on their financial advisor for information and guidance than non-users. Consequently, options users should be on the top of your prospect list since their profile is very similar to that of your best clients, i.e., they are affluent individuals, active in the market, more risk tolerant than others and are well-informed decision makers.

Lack of knowledge was cited by non-users as the primary reason for not trading options. This is your opportunity to educate and to familiarize them with strategies that will help achieve their investment objectives without taking additional risks. A more recent study[3], published in December 2009, shows that financial advisors using options, or who are familiar with them, are better perceived by their clients than those who are not using them. It can be explained by the fact that clients who are knowledgeable about investment choices expect the same from their financial advisors.

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[1] *2005 Study of Options Users Executive Summary*, Harris Interactive Inc., available at http://888options.com/press/files/harris_study_2005.pdf

[2] Although this study was conducted in the United States, findings can also be applied, to a certain extent, to the Canadian market.

[3] *Financial Advisor Engagement Study*, Options Industry Council, available at http://888options.com/press/files/fa_study_summary.pdf

The best way to start using options is with the most popular strategies based on portfolio protection, and buying and selling shares at a better price.

In the “protection” category, as discussed in the introduction, buying puts allows us to protect profits generated by an important increase in the price of the shares. Choosing the right strike price allows determining a higher or lower selling price for the duration of the contract. Since the put option is a right, and not an obligation, to sell shares, the holder still has the opportunity to profit from an increase in the share price. Conversely, on a decrease in the share price, the holder can sell his shares at the chosen strike price. In both cases, the payment of the premium is justified by the sale of the shares at a price potentially higher than the market price. On the upside, by selling the shares directly on the market and on the downside, by selling the shares through the exercise of the put options.

In the “execution at a better price” category, you will find probably the most popular options strategy of all: the covered call. The objective here is to sell our shares through the sale of a call option. By selling calls, the writer is in the obligation to sell the shares at the strike price if the holder exercises the call options. The same holds true with the sale of puts, which represents an obligation for the writer to buy the shares at the strike price if the put holder exercises them. Since the sale of options generates revenue, these two strategies are a valid replacement of limit orders. It’s the equivalent of being paid to buy or sell our shares.

Integrating options in your business plan is far more than just a new income source. They give you access to a new clientele with an open mind about trading strategies allowing them to meet investment objectives. In the end, isn’t it the ultimate objective?