

Making Markets

Volatility Draws Traditional Institutions To Options;
Changing Dynamics Offer Opportunities and Pitfalls.

By John Hintze

As a nimble, relatively small money manager, West Chester Capital discovered the hedging benefits of the options market and pounced. Run by two former options market makers on the Philadelphia Stock Exchange (PHLX), it launched its Active Buy-Write co-mingled fund in September 2005 to systematically capture call premiums on the stocks it invests in, hedging the downside risk. In 2008, it outpaced the S&P 500 index by 800 basis points, and as of April 3 the fund was in the black while the same index was down over 9 percent year to date, says Tom McKeon, who along with his partner Marne DeSantis have run a long-only fund since 1994 and manage \$100 million in assets.



“Serious money and fiduciaries are going to have to say this makes sense. It’s not gambling, it’s portfolio management,” McKeon says, adding the firm is developing several options-based portfolio management strategies. These include a collar strategy – selling calls and using the captured premium on the call sale to buy puts. “Now a lot of people are asking us whether we can help them manage their risk/return tradeoff, using our options-based portfolio management.”

Record volatility over the last seven months appears to have ramped up interest even further, especially among more traditional institutions. Ronald Egalka, president and CEO of Rampart Investment Management, an investment manager specializing in options strategies since 1983 that manages \$8 billion in assets, said his firm saw high-net-worth individuals investing in options-based strategies through closed-ended funds powering the market between 2003 and 2006. Rampart had previously catered primarily to traditional institutional fund managers, such as corporate and government pension funds, college endowments and foundations.

“Since 2003, we’ve increased assets under management dramatically, primarily from high-net-worth investors,” states Egalka.

Now the firm is receiving unsolicited inquiries from traditional institutional investors. “Because of the dramatic increase in interest from these institutions, we’re looking again for growth in that area,” Egalka says, adding, “We believe we’ll successfully close agreements with some prospects in the near future, maybe in April.”

Egalka notes those institutions have seen their portfolios pummeled, dividends cut and interest rates reduced, with prospects for near- or even intermediate-term recoveries uncertain. However, they still require cash flow to support current and future obligations to retirement beneficiaries. “If you take an S&P 500



portfolio or even an active equity portfolio and engage in an options overlay, you can create an attractive current return to provide funding for the beneficiaries,” Egalka explains. He added that the CBOE S&P 500 BuyWrite Index (BXM) benchmark has generated slightly higher returns than the underlying stock index over 18 years at only two-thirds the risk as measured by the standard deviation of returns. “Theoretically, that should not happen: higher returns with less risk,” he says.

Institutions interested in options, however, will find a rapidly changing market to navigate. Recent and pending regulatory changes appear likely to complicate the execution of large block orders, while exchange innovations and even some new exchanges are likely to create a spread of advantages and disadvantages.

Making Cents

The options exchanges’ penny pilot program, for example, was launched in January 2007 and required quoting contracts for 13 options classes in penny increments, rather than the traditional 5 cents or 10 cents. It was expanded by the end of 2008 to cover 63 classes representing more than 50 percent of trade volume.

In a series of analyses since the pilot began, the options exchanges reported dramatic decreases in spreads as well as liquidity, the first a plus for investors and the second problematic for block orders seeking electronic executions, before volatility began in earnest last fall. “The institutional investor is significantly impaired. Once you get to sizable orders, liquidity in the

penny pilot names dries up pretty fast and you’re better off working the order in a more traditional way on the floor,” Egalka says.

Penny quotes, however, also benefit institutional orders. Bridgeway manages \$2.5 billion in mostly long assets and has employed an options-based strategy for its \$45 million, eight-year-old Bridgeway Balance Fund, which uses options in an effort to capture 40 percent of market gains while limiting losses by the same percentage. The firm also uses options in two other fund strategies, but its orders, averaging a total of 250 or so contracts a day, tend to be small enough to avoid running into liquidity shortages.

Richard Cancelmo, who runs Bridgeway’s Balanced Fund and heads the firm’s equity trading team, notes buying calls to close a position when the bid is 10 cents and the offer is 20 cents may require paying at least 15 cents, or 50 percent over the bid. “With pennies, I may be able to bid 11 cents, and that’s attractive rather than the minimum increment of a nickel,” Cancelmo says.

The penny pilot echoes the equity market’s move to quoting in decimals in 2001, and it has prompted similar market-structure changes. The maker-taker fee model that has become prevalent in equities, along with high-frequency trading, and it is now offered by three options exchanges: NYSE Arca; the Boston Options Exchange (BOX); and NASD Options Market (NOM). Although they typically execute less than a quarter of market volume, a Securities and Exchange Commission decision to expand the pilot to more classes, anticipated

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in July, will almost certainly push more volume their way.

Those exchanges rebate limit orders and charge for market orders, whereas the other exchanges require market makers to contribute a portion of their revenues to a pot that is distributed to broker-dealers providing “customer orders” from retail and institutional investors. The latter exchanges allocate executed contracts according to each participant’s order size at the best bid or offer, in contrast to the maker-takers that execute orders according to price/time priority.

Active liquidity providers are crucial to the options market, in which each options class has multiple strike prices that disperse liquidity. The allocation model has been highly successful in drawing retail and institutional orders, and since trading with those types of orders is profitable for market makers, the approach has effectively attracted both sides to options contracts and resulted in highly liquid markets.

However, penny quoting and competition from maker-taker exchanges have forced the traditional exchanges to lower payment for order flow. Meanwhile, a new source of liquidity is arriving from high-frequency equity players entering the options market. Their strategies to take advantage of price discrepancies tend to favor maker-taker pricing, where they can post a limit order to receive a rebate and then potentially lay off the position

in a traditional exchange for free. Getgo Inc., a high-frequency powerhouse, has approached the market, and Lime Brokerage, which caters to high-frequency equity traders, is building an options trading platform.

While the exchange companies are juggling how best to continue drawing both market and limit orders, potential rivals are now considering entering the options arena. Kansas City, Mo.-based BATS Exchange is in the process of deciding whether to leverage its high-speed equity-trading platform, which pioneered a highly aggressive maker-taker fee structure, in the options market. Direct Edge ECN has also expressed interest, and the Chicago Board Options Exchange (CBOE), one of the top two options exchanges that relies on the traditional allocation model, has applied for a second exchange license that is likely to offer maker-taker pricing. An influx of new exchanges could result in the type of pricing war that have driven fees down to razor-edge levels in the equities market.

CBOE Executive Vice Chairman Edward Tilly says the exchange is “optimistic for a ‘June-ish’ approval” from the SEC and plans to launch the exchange shortly thereafter. He adds that it “might make sense” to offer two pricing models for highly liquid classes, such as a major index option, but less so for less liquid single-stock options. “A second exchange medallion would allow the CBOE to continue business as a traditional exchange and try to attract new users with a second exchange,” he says.

Retail investors also tend to favor pennies, although maker-taker pricing can be problematic for their broker-dealers. Randy Frederick, director of trading and derivatives at Charles Schwab, one of the top providers of options order flow, said “the vast majority of retail traders like penny pricing a lot because it gives them a truly transparent marketplace.” However, they typically execute market orders, which generate fees when orders are executed over the maker-taker exchanges. “We have to absorb the maker-taker fees as a taker [of liquidity]; we can’t really pass that on to customers. That’s an issue,” Frederick says.

The traditional exchanges such as the CBOE and In-

ternational Securities Exchange (ISE), each with about 30 percent of market share, view penny quoting as appropriate for the most liquid options classes but encourage nickels and dimes for the vast majority of classes. Both have recommended limiting pennies to options series with premium values of less than a dollar, and applying nickels and dimes to those with larger premiums.

Despite the penny pilot, record market volatility widened spreads last fall. Although unfortunate for retail and institutional investors, the wider spreads are highly attractive to market makers and other liquidity providers. Boris Ilyevsky, head of business development at ISE, says the exchange “saw an increased number of inquiries” about becoming an exchange market maker over the last year.

“We’re seeing more and more clients that haven’t been anything but an equities shop saying they have to be in the options market,” says Anthony Saliba, president and CEO of LiquidPoint, an affiliate of BNY ConvergeX Group that often executes double-digit percentages of daily options volume. Saliba adds that his firm provides algorithms to channel order flow to a dozen or so market makers, and now it’s tweaking the software to make the service available to new entrants. “We’re building it out to make it more plug-and-play for the smaller guys,” he says.

Ilyevsky notes, however, that while still historically high, volatility, fueled last fall by the SEC’s ban on short selling 1,000 financial stocks and new delivery requirements for securities borrowed in short sales, has fallen sharply. Plus, the high growth seen in the options market over the last five years, which made up for the tighter spreads resulting from the penny pilot, is widely expected to slow. “If these trends continue while there’s this huge influx of liquidity providers, their profitability is very likely to fall,” Ilyevsky says.

Tighter spreads, compounded by new short selling rules the SEC is considering, could end up reducing options liquidity providers’ incentives. Although market makers are expected to be given an exemption from new short selling restrictions, it’s unclear what form that will take. In addition, tighter delivery requirements on borrowed securities have placed borders around market makers’ ability to short stock to hedge their positions.

Egalka notes that Rampart relies on market makers to execute its larger transactions. “When shorting is taken away or restricted, it can impact the liquidity we have available and what we’re trying to accomplish,” he says.

The battle among the exchanges to draw liquidity has definitely begun. The maker-taker exchanges’ fee on liquidity takers has prompted broker-dealers servicing

retail and institutional investors to place them last on their routing tables. To change that dynamic, the NASDAQ Options Market (NOM) eliminated its take fee April 13, leveling the playing field with the traditional exchanges, including its affiliated NASDAQ OMX PHLX, for retail and institutional orders. “That’s not really a maker-taker model anymore,” says Saliba.



Looking Ahead

Meanwhile, the CBOE recently received regulatory approval to give institutional users of its Flex Options program greater choice over expiration dates, enhancing the ability to customize contracts that investors might otherwise seek in the OTC market. “We’re very excited about attracting OTC users,” Tilly says.

At least one expert in exchange companies is bullish on the options exchanges’ futures and, by extension, the options market. Caldwell Investment Group specializes in exchange investments and owns approximately 5 percent of the CBOE and a portion of the BOX through its stake in Canada’s TMX Group, as well as multiple other exchanges worldwide. Chairman Thomas S. Caldwell says once the financial system is stabilized and extreme volatility is mitigated, “that speaks to volume increases again” in options. Although declining to provide specifics, he added: “We’re increasing investments in the options markets in the U.S.” ○