# Evaluating the Options

Disruptive Forces in Investing

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**Vanessa Rosenthal:** After more than a decade of relatively calm equity markets and falling interest rates promoting spectacular portfolio returns, market volatility is back and doesn't appear to be going away anytime soon. Volatility can mean different things to different investors, but to option investors, it means higher-dollar premiums and more money for the taking. Yet the complexities of options investing might be daunting to many. Today's guest will shed light on how the opportunities are there if you're willing to go find them. I'm your guest host, Vanessa Rosenthal, and I'm here with Derek Devens, managing director and senior portfolio manager of the Options Group at Neuberger Berman; and we'll speak today about what the options are in options investing. Derek, thanks for joining me today.

**Derek Devens:** Thanks, Vanessa, pleasure to be here.

**Vanessa:** So just to get started, can you give our listeners a brief overview of how you think about options as an investment universe? I suspect that many think about them as a niche market, but what are your views?

**Derek:** Well, I mean, I think it's becoming its own asset class. I think, you know, people think about option markets; but they're kind of grounded in 20, 30 years ago, where you had some quantitative ideas, founding a new market; much like high yield or any of the other markets that evolved. And now we sit here today with trillions of dollars in open interest across many different indexes, single-name options. There's any number of strategies out there, and it's really blossomed through both regulation improvements as well as just investor adoption; that it's – what was the Wild West is now Main Street. And you see it in the news. You see it everywhere, and I think people are becoming more familiar with it. And so it's – again, I think the best categorization would be, it's its own asset class.

**Vanessa:** So if it's so big, and sounds like it's growing, why don't you hear about more investors using options?

**Derek:** Well, it's a complicated space. I mean, there's any number of, you know, reasons that you see, investors being hesitant. I mean, one, you see a lot of people make mistakes. People lose a lot of money in options very quickly, and I think that fear precipitates through the option market in, particularly, the investment space. And then that, that fear becomes almost career risk if it's your, if you're a professional investor. You certainly don't want to be the guy who takes the risk, or the gal who takes the risk, in investing in options, and it doesn't work out how they planned. And then for individual investors, it's similar. It's complicated. Sometimes it's expensive. You know, you've seen zero commissions come down in a lot of equities. It used to be expensive to trade options. It's become more competitive, at least. So when you add up complexity, risk, perception, history – history is not on the side of option markets, and people have made some, you know, comments about how dangerous they can be for investors. So all that combined just makes it very hard to kind of adopt out of, out the gate; and then, on top of that, fitting it in portfolios can be a challenge, too. So you have kind of new ideas that we call – we often call it – it's the oldest new idea, right; the idea that it's been around so long, but every time you talk about it, it's like, oh, well, that's kind of interesting. And so the cycle kind of repeats itself. But I think we finally, over the last decade or so, have made some big strides in that. It is definitely, as I said, more mainstream, and it, it's here to stay.

**Vanessa:** Yep. But for some, it's, you know, a new universe to some extent, others getting more comfortable with it. But, so how do investors figure out what they should do within options?

**Derek:** Yeah, I think more than anything, you got to know why you're going to the option market. You know, people know why they buy bonds. They're okay with interest-rate risk. They know why they buy equities. They like returns, or they like the story. When you go to options, it's a lot more opaque. Like, why – well, why are you in options? What are you trading in options? And that's a harder answer. I think it challenges, kind of, people's investment souls more than any other space, because of that lack of clarity.

So you really need to understand why you're going. Are you going to kind of speculate on something, or are you going to try to hedge a position? Are you going to try to kind of, kind of similar to fixed income, clip a coupon or find a premium to carry some yield or make some additional income? So it, it's really, really important that investors kind of know what they're going to. It's an expectations game. Uh, if you get caught too much with thinking you're going to change your ideas or, or try to trade the market, I think that's where you run into the most trouble.

Vanessa: Yep. And, and often you hear about the VIX hand in hand with discussion around options. So let's talk about that for a minute; the CBOE, S&P 500 Volatility Index, aka the fear index or VIX. What do we need to know about that?

Derek: Yeah. Well, uh, the VIX is what I consider kind of the front man of the option markets, right? If you're, if you're a big, successful global band or music group, usually you have the lead singer, the front man, that everybody knows. I mean, we would – kind of – the other day, uh, we were joking over lunch that everybody knows Bono, but I don't know – I can't name another member of the U2, right, I mean as embarrassing as that may be. So VIX is that front man for option markets. And it's probably the biggest innovation, at least in my space, to geek out a little bit, in, you know, the last 30 years. I mean, to make something that synthesizes some really complex ideas down into one number, and then have it be picked up by every new – uh, news media outlet, uh, around the world as a barometer – the fear index, the barometer of risk – is really powerful and has really helped commercialize; and, and as violent as it can move day over day, it's really helped, I think, investors kind of adopt options.

Now, very quickly, what is it, is probably the most important thing. You know, it's a lot of things to a lot of people; but what it is just the prediction of the option market. So let's just keep in mind, it's only about 30-day risk. So VIX is based on 30-day options in the S&P, and it's really just like an average of what the market thinks the S&P 500 can move, up or down, over the next 30 days. Think of a dispersion or movement, volatility, if you will; and it really is just telling investors how wide that outcome might be. It doesn't tell you about the direction. It doesn't tell you about what the market's going to do. It's just a prediction or a price of risk. So it gives investors an idea of how much risk or dispersion the market's expecting; doesn't mean it's going to happen, and it doesn't tell you it's going up. VIX was in the high, you know, 30s, 40s, 50s earlier this year; and the market has rallied significantly.

So even though we call it the fear index, and that's what it's lovingly called around the world, it's really – has more about – it's fear and greed, right? It can be more of a – it's why it's volatility. So it's important just to remember, it's telling you how much dispersion or market risk the market is pricing in; not how much there's going to be, and not which way the markets are going. And that's – if you can keep that in mind, it really helps, um, maybe keep your wits about you when it's going to all-time highs – the 82 in March – and then it goes to lows in 2017.

You know, it, it's really there to, to be an instrument, another thing to kind of look at and understand.

Vanessa: So it sounds like it doesn't necessarily have an implication for market direction. Why does it seem that it's bad for options strategies when the VIX jumps?

Derek: Well, volatility is kind of in its pure form, a, a form of, uh, leverage, right? The more risk you take, it – the theory goes – the more return you should make. So if you can trade something that's very volatile, or you can be in a market with a lot of volatility, that means you can put, uh, less money in it and, hopefully, have bigger outcomes or wider outcomes. The problem is, they don't always go in your favor; meaning the outcomes can be down markets or up markets, and depending, in options, where you can be long or short, sometimes both simultaneously. You can end up with some pretty big moves either one way or the other. So VIX, sometimes we think of it like a big bull. It moves a lot, and very strong, in certain directions; and if you're not ready for it, it catches half the market or some of the strategies, you know, mis-seated; and they get thrown off. And that happens pretty regularly, and so it doesn't really matter, um, kind of, the level it is. So it's more the violence with which it can move or buck, if you will, is what catches a lot of investors off guard. You think that it's being very well tame. It looks nice. Everything's going okay. And then the next day, it's angry for some reason; and the market seizes up. And option markets, much like credit markets, repriced credit spreads when, you know, defaults start to increase; but you have to remember, everything is amplified in option markets because – or in equity option markets – because they're based on equities. So it happens much more quickly and much faster, uh, in option markets, and particularly equity option markets. So that usually leads to the, the violent outcomes that you see.

Vanessa: So let's get back to the investing side of things. It's always seemed to me that most options strategy outcomes are fairly binary. Why is that?

Derek: Well, similar to, to what we were just talking about, if you take something that is a little unpredictable in and of itself – because there are behavioral elements to VIX, right? It, it's not just what the market is saying. It's not just that people lost a bunch of jobs. It's not that, you know, GDP is down. It's also the outlook of, you know, consumer spending and a lot of different behavioral elements; um, liquidity, uh, fear of risk aversion, right; loss, fear of loss rather than fear of greed. And then sometimes, like in the late '90s, you get greed that kicks in. So there's behavioral elements of it that, that, that drive it. So what happens is, you get a lot of what we call kind of strategies that, we say, fly through the derivatives triangle, kind of like the Bermuda Triangle. You know, there's three things, right? Leverage: You really want to avoid leverage. They're inherently leveraged structures, right? You can – premiums are small relative to the amount of notional or amount of security they control. So you get leverage in the markets pretty easily. You don't want to add to that problem excessively. Second, you don't want to be too complicated. Not owning what you – uh, not knowing what you own and all the interactions that can happen, and, and you think about some options strategies that will literally have hundreds, if not thousands, of positions; they can become very complicated very quickly. And they become very hard to trade. So that, that in and of itself, you can overcomplicate things. You've got to keep it simple. And then, in addition, there's the human element of tactical. Everybody – it, it's hard to do nothing sometimes. Options are a great market to just wait and let time go by, because in theory, you are getting paid for that time. It's called beta, but you get paid to wait. But being tactical in a leveraged space just compounds your problem, right? You're trying to move one way. Market zags the other, and you can really compound and really, you know – compound on your mistakes very quickly in options. So you really want to avoid that derivatives triangle that we – you know, one or two elements is okay; but when you start to go through all three, it, you can really have, uh, risk of ruin pretty quickly.

Vanessa: And why do you believe that investors need options strategies now more than any time in the past or other points in the past?

Derek: Well, what we're kind of pointing at is the 60/40 problem. You know, for, for most of the last couple decades, being in equities and fixed income in some form of blend, with equities having stellar returns, uh, generally speaking; and, and interest rates coming down for – to help your fixed income over the last couple decades; it's been a perfect recipe. It's been, it's been great. It's been stable. It's gotten a great return. It's lower vol. But largely with interest rate approaching zero and equity valuations – I'm not an equity manager, but at least equity valuations at reasonable levels; I don't know if they're expensive, but they're definitely not cheap. Uh, what else are you going to do in the portfolio? So when we think about, uh, interest rates and that 60/40, we really are focused on the idea that this is another way to earn or monetize or pull in premium, right? You have capital appreciation and dividends that work great when they work. You have fixed income that does very well when it there's yield to be had. But what do you do right now? Well, we think you can go out and monetize some of that market risk, right? Credit risk is one. Equity risk is one, and then there's overall equity market risk or market risk, vis, vis-à-vis VIX. And VIX is very correlated to, to credit markets. So if you think about credit spreads as a barometer of risk, VIX is an equity barometer of market risk, and so you get a very nice third leg of the stool in monetizing market risk.

Vanessa: Got it. Um, any other advice for our listeners on how to be successful in option investing?

Derek: You know, I would just echo what any investor would probably say; is, one, you've got to be long term. I, I don't think you can walk in and expect a win for a week or a win for a month, and unfortunately when people win over short periods, they think they can win over the long term. But you, you got to have a strategy that is really for the long term. You're going to have days, as you already mentioned, you know, violent moves in VIX or when things go horribly wrong. So you really got to, you got to be ready for those, right? You're an insurance company, in many respects; or you're kind of signing up to, to help a market function, and providing capital and liquidity. And you do that over the long term, just like you would buy a bond or an equity and hold for the long term. It just so happens your options expire more frequently, and you just got to reset your exposure. So long term is, is very important.

And then I like the KISS principle. You got to keep it simple. You know, the more complicated you make things, the more you think you know, the more you run the risk of, one day, things are not going to be that way. And it just, it, it dents your portfolio to a degree that you hadn't anticipated. And then you're forced to change something or buy out of a position that's too expensive, and it just compounds the problem. So you got to keep it simple, and then that last one: Leverage is exceedingly important. I've seen the best strategies over time that look just infallible be levered, and then it just takes one or two days. So the leverage is always the – the greed always seeps in. Um, but you got, you got to be the conservative risk underwriter, right; going back to the insurance analogy. You got to plan and expect the worst, and then if your expectations are right, and you, you have a good, stable strategy, you'll be just fine and make your money over time. Nobody, nobody in options – it may seem like it, but nobody gets rich overnight in options. They always have stories. Everybody walks out of the casino a winner. It's not how it works.

Vanessa: All right, that's very helpful. Okay, so let's do a lightning round to wrap this up. Um, just give us the first answer that comes to mind. What is the biggest challenge in options investing?

Derek: Without sounding too cynical, it's definitely the people. Um, I've seen the best strategies – uh, and that's not a slight on investors or any of my competition. It's just simply, I've seen some of the best strategies and how they sell them, and all the complicated ideas; and you know, options is a place where there have been high fees for years. There've been all sorts of incentives, um, and I, you know, there's nothing worse than some of these basically preposterous return streams and things you see in options. It's how you – I mean, how else do you get attention, right? It's already –

Vanessa: Right.

Derek: – what you said at the beginning. How's – it, it's somewhat of a niche market, so how do you get attention? How do you pry the dollars out somebody's portfolio that was doing well in equities or fixed income or private equity or alternatives?

Well, you got to show them something different. And I think our industry all too often goes a little too far in, um, showing the, the shiny new toy or the, the brand-new Ferrari that looks like it's going to do, you know, go really, really fast. But it's very expensive, and that just doesn't end well. So that's the biggest challenge, is kind of just the, the people.

Vanessa: What new ideas are you looking at?

Derek: You know, we, we go slow over time; but I would say this. For the first time, we've started looking at volatility and say, like, long-term Treasuries and things of that nature. Uh, back to our market risk or how you're going to get paid, you know, a bond is largely a short put, right? You collect a premium, whether it's a fixed income – or, excuse me, a, a corporate bond or a Treasury. You collect a small coupon or premium to take downside risk, um, even if it's small downside risk in a case of a Treasury, or more downside risk in a case of high yield. But you collect a – what's right now a paltry premium or coupon to take some pretty big risk, we think. And we think there's some pretty good opportunities to go out and restructure that and get paid for those risk in, in the form of, maybe, short puts or collect a premium to underwrite those risks; again, the market volatility; and get paid in a different way but take very similar risks. So it's, it's a way to supplement or augment, kind of, that 60/40 problem, focused on the fixed-income side.

Vanessa: Mm-hmm. And what's your favorite part of options investing?

Derek: Oh, uh, you know, I, again, to be a little bit of the geek or engineer, it, it's got to be the math and – if the people are somewhat the challenge for me, then that, by, by logic would mean the math may be my comfort or my blanket, I guess.

Vanessa: Mm-hmm.

Derek: And the math says that option values decay every, you know, day, every minute, actually. While we've had this conversation, we've actually – option premiums have decayed in our favor. Now -

Vanessa: Right.

Derek: – that doesn't mean they don't fluctuate, like any stock price or, minute over minute as their real-time quotes; but the theoretical value of those assets are wasting. They're decaying away to our benefit, just like – just like coupons accrue or yield accrues in fixed income, premiums decay in options. And you can be in a position to profit from that decay. So that's a fun concept. I mean, everybody loves to get paid to talk; so to think that our investors are getting paid while I sit on a podcast is pretty powerful.

Vanessa: That's true. Okay, well, thanks so much for providing your insights today on options investing. It's been great to have you, Derek.

Derek: Oh, my pleasure, always enjoy it.

Vanessa: And, as always, you can subscribe to the show via Apple Podcast, Google Podcast, or Spotify; or visit our website, www.nb.com/disruptiveforces, for previous episodes, as well as more information about our firm and offerings.