Amid the Volatility: What Are Investors' Best Options?

Disruptive Forces in Investing
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Anu Rajakumar: With a tumultuous few months ahead of us until the end of 2024, today we turn to an investment category that doesn't shy away from market volatility, the world of Options. We'll learn about how option strategies work and ask what investors should be aware of if trying to time the market with such strategies. Finally, given what's happening in the macro environment, what Options do investors have when it comes to navigating volatility? My name is Anu Rajakumar, and joining me today is Derek Devens, Senior Portfolio Manager of the Neuberger Berman Options Group. Derek, welcome back to the show. It's been a while.

Derek Devens: Thank you, Anu. It's good to be back.

Anu: Derek, let's set the stage here for our listeners. I've got a two-part opener for you. For those who may not be as familiar, give us the basics, how does options investing work? Secondly, since we had you on a couple of years ago on the show, how has the Options space evolved in recent years?

Derek: Yes, it's hard to sometimes sum up what option markets are or how they work. Everyone's familiar with fixed income and equities have been around for everybody's career and easy to understand relatively. Sometimes people refer to option markets as casinos and can make some loose analogies there. The quickest way I'd often describe it is that imagine if insurance companies were insurance businesses as well as lottery ticket writers.

You combine the insurance and lottery and then we are able to trade the policy. You name an asset, you want to go out and insure, or you want to go out and speculate on it. There's a company or an exchange or something that will help you write that policy and through that, you're able to then go out into financial markets and create all sorts of products or structure certain payoffs and then there's end markets for both. Now more formally, that's the good old-fashioned hedgers and speculators and hey meet in the option market every day and expressive view. I know we'll talk about events in the future and what people are thinking and what people are pricing, but it makes for a very efficient way, much like other handicapping, or betting or speculating, or insurance, for those to be expressed and that meets in a financial market. Now as the evolution has grown, that concept has been around a very, very long decades, going back to the '70s and '80s with futures and options.

Really over the last couple of years, you've had three real big developments. One, you started to have more popularity, more investor education. You read about it in the news and it's more mainstream. You've had regulation, be more accommodative. Options have had a very strenuous regulatory environment for obvious reasons. They involve leverage and complexity and such and then you've also had firm capabilities. You've had different firms grow, different platforms.

Technology, the ability to clear them, settle them, trade them, is all improved on a basically global basis so when all of that comes together, and then I would say the real additional element that's been the kerosene on the fire has been zero rates. Until recently, everyone was looking for additional income, additional exposure, additional capital efficiency and so whether you're a high net-worth investor or you're someone with a retirement program, you are looking to get more out of your portfolio and Option markets have been a heavy focus of that.

Anu: All right. Terrific. That's a great background. You mentioned events in the future, you mentioned the zero-rate environment going up to a higher rate environment, and now of course we're looking forward to the next FOMC meeting and potential for some interest rate cuts. So given that everyone's anxiously awaiting the upcoming fed meeting and what's going to happen, talk us through how that may impact the Options trading market.

Derek: Option markets love change. When you think about just investors generally, it's ironic that doing nothing is always the hardest thing. So what we've had over the last couple of months is this anticipation that in the next couple of weeks, when is the Fed going to start cutting rates? And one, that signals that inflation has largely been tamed and is as much as you can say under control, it's under control. So right now, we're in that positive event and so the ironic thing is that everybody's waiting for that change. And so Option market's very much like anticipation.

They like volatility, they like the uncertainty. Right now, with the FOMC being somewhat appropriately predictable, even though you can't ever predict if the next cut is the following meeting or the subsequent meeting, and we're going to have two or three cuts. So there will always be something that we're speculating about. Right now, you had this nice period of, "We know it's coming, the question is when." Option markets price set in pretty quickly, S&P isn't very volatile and then you now are getting closer and closer. So, it will move from this meeting to now, is it one cut or is it three cuts?

If we go too far, that's probably too bad because it means we're starting to try to help the economy with lower rates. If we don't go far enough, then inflation may come back. And so it really sets up well for that uncertainty. This seems like a very uncertain time, but we really haven't seen anything and nothing's really been done except waiting, which tends to be the less volatile time, if you will, even though everyone's antsy about it from that perspective.

Anu: So you said that options markets like the uncertainty. Post-Fed decision, what happens in options markets next once they know what the direction has been for September, what do you predict will happen in Options markets?

Derek: So what's really unique about these next couple of weeks is you're coming off the heels of the end carry trade. We haven't really named the vol event that happened in early August or somewhat lovingly calling it the volcano. It was Vol Mageddon in 2018. We've been calling it the volcano because of its rapid ascent and rapid decrease but that's a little conflating with the uncertainty around the economy and rates right now, because you've had VIX increase, which is a direct barometer of anticipated risk premiums for those option policies or option premiums.

And the uncertainty now around, well, once the fed cuts, will there be more? It's really more of a higher level of volatility and option premiums will probably be persistent. So again, volcano kind of jumpstarted things more than I think anybody anticipated because that's how these things work. Nobody anticipates them. On the heels of that, having the fed decision, they'll very quickly start saying, "We don't know if half a point is enough, will there'll be 100 basis points by mid-next year?" All that needs to get priced in, and usually that's a slow process. It's not a VIX collapses back to 11 just because the fed cuts rates, it's now things are in play, things are moving, it's harder to price that.

You probably get a little bit more volatility, not a lot, but you are biased upwards as opposed to the last couple of months, or basically year to date until August. You've been basically anticipating a fed cut. You've been biased to the lower end of VIX. You saw that. Every time it went up a little bit, it would decrease pretty quickly. That changes once the Fed I think is in play.

Anu: Of course, the other big uncertainty for Q4 2024 is the US election. Talk us through how your team sees that uncertainty. How does it play up to November 5th, and then what's the election impact once we have a clear winner?

Derek: I will start with what I think the market is saying, and then I will share what we as a team maybe talk internally. I think in volatility space, in particular, is the US economy is now bigger than US politics. You are not necessarily able to just look at an election and say one party's politics are going to unwind the economy or help the economy more than the other. Neither of them ever have an invested interest in harming the US economy. When you look at the global nature and all the geopolitical events that can affect US companies, particularly when I say US economy, it's the S&P 500 or similar. That has moved well beyond, are we worried about an insurrection in January of 2025?

As much as we want the news and we think the volatility and instability would propagate into financial markets, I think time and time again it does but you can look at some of the crises around the world right now and say they're not really moving markets and they could very quickly catch fire and be everyone's problem, not just a regional problem. So to think that this election outcome is going to materially affect the next 12 to 18 months, I think is what the market's going to say as far as volatility. Now, when you start talking about 24 or 36 months down the road and some of the policies, that becomes more of a fed/fiscal policy. Then what does move it is this idea of what we just talked about, the feds first move, where are they going to go?

They have a runway here to do what they can to control inflation and not harm the economy but after that, it's going to be when the new administration or the current administration is 12 or 24 months into their term, having made policies that could really impact the deficit or spending or certain industries.

So again, as I started, I think the economy has gotten a little bigger than US politics, although we are all very consumed and ad spending for politics is hundreds of millions of dollars in two or three months. You can't ignore it but it's not necessarily the big thing. Now, internally, I think both just spend money. It just depends how you spend money. One wants you to think they're spending it on good things and it's fiscal and the other party thinks, well, we're going to cut the deficit but we're going to spend it on all sorts of other policies or defense or things, so it's not going to shrink the deficit.

It is just how we grow the deficit or what we say we're doing. So again, that's all the more reason to maybe make for good TV but not necessarily pay attention from my volatility portfolio perspective, it's priced pretty efficiently by markets, and it gets priced very quickly. For anyone who's not familiar with option markets, volatility will change instantaneously minute by minute and that's both a blessing and a curse.

Anu: Yes. No, absolutely. That makes a lot of sense. As you mentioned, lots of critical events in the coming months. When you speak to folks who are interested in these strategies, how do they think about market timing and sizing their allocations when they're considering option strategies?

Derek: Yes, there's probably three big buckets. If you're looking to hedge, we think of hedging just as you should any insurance that you buy. Right so you don't go out and think about buying homeowners insurance or auto insurance to make money. If you do, you should just sell the asset and invest in T-bills or part of your portfolio and there was a great headline the other day, like T-bills and chill as a strategy. I like stuff like that.

Simple is good in financial markets, particularly when you have so many options, I guess I'm making the options pun now, options in the industry that you can keep it simple. If you're going to hedge, just think of an annual budget. Just say, "Look, I want to lower my portfolio risk. I have some low-cost stock I don't want to get out of, let me just go ahead and have an annual budget, 1%, 50 basis points," whatever, and just buy some insurance. It's very simple. It's time-tested. It will work when you need it but just be honest with yourself.

There is no free lunch. It is hard active management. Equity's hard. Fixed income and credit selection is hard. Timing Option markets is just as hard. I have kind of the analogy of you cannot time—you know Option markets are always trying to forecast what might happen in the future and you don't forecast the forecast of a hurricane. Noah and the European model forecast hurricanes. Nobody's out saying, "Oh, I can out forecast Noah." When option markets say risk is what it is, that's a pretty big, broad, accurate barometer of what risk is.

So there's hedging. If you're going to speculate, it's a pretty simple rule of fixed costs. Again, only what you're willing to lose. It's once a year when I'm in Las Vegas for a convention or something like that, it's kind of entertainment money. I know that we were going to talk also, I'll jump to it about the zero days to expiration options. A great example of everybody on the internet hears about the big winner every day.

It seems great and it's great for the industry because it's basically a scratch-off lottery ticket that everybody reveals at the end of the day, there's no overnight risk, there's none of that. If you're going to speculate, nothing wrong with it. In Option markets, it's easy to do because everybody can always rationalize something. It's not just watching balls bounce around in the machine or scratching off a ticket. Everybody has a view. Is it a single stock? Is it the Fed meeting? All of that. Just be willing to what you lose.

In the third one, there are some really, I think, good ways of capital efficiency. Take your assets, whether they're dormant assets, what we call low-cost basis stock or long-held positions, or big bond portfolios that you can access additional income, you can do some strategies to enhance. Now they do involve some implicit leverage or additional exposure, but they do work harder for you. Institutions have done it for decades and now it's being brought to high net worth and the masses if you will, so that you have access to those. Those are the big three, but just keep it simple. If you don't understand it, probably best to do your research and then go small to begin.

Anu: Or ask ChatGPT and it still don't understand it. Reach out to Derek and he'll walk you through it. Actually, that kind of makes me think of another question. Derek, are there tools or resources that you rely on to help you stay informed about market movements and volatility?

Derek: It's funny to say, with all the information out there, you try to just go direct. Everyone really, in the grand scheme of things, has the same information. What I don't do is we definitely don't pay attention to the first breaking news coming on the headline of the morning we wake up and come into work on a Monday and it seems like the world's imploding because the S&P is selling off overnight or volatility is spiking in option markets. You can't take the bait on the first thing. Any insightful piece now, even when we talk to the press, they're doing their research.

Usually, it takes a week or two to write an article about Options. Anything worth reading was not written in 30 minutes over coffee and then put on the air or what have you. As much as, again, it makes for good TV or good clicks or good internet, it's really not that informative by the time we want to react. Secondly, if it's that important, then your strategy probably isn't the right fit for you. If you are having to move with the market, I would say over time, that generally is a losing strategy.

Anytime you're that reactive or you have a position where if this happens, I have to get out immediately, you probably don't have all the scenarios covered and everybody uses the time horizon, you don't have a long enough time horizon. That's true. It's also a function of what you're trying to accomplish. Really going back to what we said earlier. If you're buying insurance, leave it on. You bought it for it to work knowing it's ultimately going to cost you money.

Don't beat yourself up about, did I time the bottom correctly? You don't want to do that to yourself. Having the staying power and not getting shaken by the news is really one of the things I think investors pay us for, quite honestly, so that they wake up on Monday and the world doesn't end and we keep doing what we do.

Anu: That's great advice. The sensationalism in financial media can give you palpitations a lot of the time. Derek, we've talked about possible scenarios with rates and elections. Just to wrap up, how should investors balance risk and reward when their considering Option strategies for their portfolio?

Derek: Again, it's hard to do it without the three things. The one I think it's just know what risk you're willing to take. The way we think about risk is we call it the derivatives triangle. When you look at your portfolio, you kind of say, "Look, I don't want to be in options." You can be tactical. Trades can be very complex or structures can be very complex and they can involve a lot of leverage. If you take those three things in isolation, they make a lot of sense.

You can have a good structure, you can have a lot of complexity, but you don't want leverage on one of those. We call it the derivatives triangle, much like the Bermuda Triangle. You don't want all three in your portfolio at once. When you think about sizing, look at your portfolio and say, "Look, am I very conservative? Do I have a lot of bonds and not a lot of Equities?" Well, then an overlay that generates a little extra income that has some equity risk may make a lot of sense for you.

What we don't want to see, or what we see time and time again is a strategy that's promising, outrageous, and I use that word loosely, but outrageous or unlikely outcomes, like no risk, but you get all the reward. Those types of strategies still get pushed really hard in markets. Zero downside over the next year but you should get upside. Guys, that's a risk-free investment, that's a T-bill. Zero downside? You don't get paid in this world and take no risk.

Back to your question about sizing, it really comes down to looking at your portfolio and see what risk you can take. Once you decide what risk you can take, you pretty much will know how much in dollar sense or in volatility, that kind of fits, but I would say it's more about what risk you can as much as it is about how much. I think investors in Options sometimes forget that. They think, "Oh, I put $100 in this equity. I want it to go up." Yes, you put $100 in an Option trade. It's very different. Did you take the risk you want to take just as much as was it the right size?

Anu: Yes. That makes a lot of sense. It also seems like time horizon is an element of that as well, because you think about your risk sizing, what's your time horizon? What are your obligations that you need to meet? Those are all important things to take into account when you're considering investment strategies like this. Derek, thank you so much for sharing these thoughts today. Before I let you go, I have to ask you a quick bonus question. If you could pick a volatile/dangerous activity to participate in, think of a high-risk but fun, adrenaline-rushing activity, what would it be, and why?

Derek: Oh. The other day, just coincidentally, somebody, they have one of these indoor skydiving things. The people were talking about that in the parties they do, and my kids, oh. It's like, "No, I'm never throwing myself out of a plane." There is the definition of tail risk right there. The Option guy does not throw himself out of the plane ever, but I'd have to go with the IndyCar. I don't know. Going 200 miles an hour with Lewis Hamilton would just be terrifying, but very safe.

Anu: Okay. You take that tail risk.

Derek: Yes, right? To me, that's I'm hedged a little bit. I'm in a ton of protection. It couldn't be more state-of-the-art. You want to talk about a quant investor, like those F1 cars. If you can blow them up at 200 miles an hour. I could do 150 and be just as terrified and have very little outcome. I'm going to go F1 racing.

Anu: That'd be a thrill. For what it's worth, I have jumped out of a plane, and I will not be doing it again.

Derek: Okay. I'm glad you want the tail risk.

Anu: Exactly. Derek, we've hit on a lot of key issues that I know are front and center for market participants at the moment, not just the basics of Options investing, but also just the implications of rates and election volatility on the options market. I think importantly, a comment that you made a couple of different times is that Options strategies are really more of a long-term play, rather than something you should really try to time perfectly.

It sounds like it's better to really think about how much risk you're willing to allocate based on what you're expecting and your time horizon versus again, how to potentially time the market. For all of the thoughts that you've shared today, we appreciate you coming and look forward to seeing you again soon.

Derek: Thank you very much.

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