

## Options Are Ideal for Lowering ETF Risk

Dan Haugh from PTI Securities notes how using options adds protection to an ETF investing strategy.

By [Liana Madura](#) | 09-15-11

*Dan Haugh is one of the founding partners of PTI Securities & Futures, a high-end trading and money management firm headquartered in Chicago. PTI brokers utilize options and other relevant financial instruments in tandem with underlying securities, with the target goal of maximizing returns. Haugh recently answered our questions on how a single-index exchange-traded fund portfolio strategy operates, along with its benefits and risks. He also discussed how managed ETF strategies are gaining popularity and interest among investors especially given current volatile market conditions. Lastly, Haugh also mentions the short-term opportunities he is seeing for investors.*

### **1. Can you elaborate on the single-index ETF portfolio strategy along with options used to help protect against downside protection?**

PTI Securities uses broad-based ETFs as a core position, but we also use options on these ETFs to significantly lower the volatility of investing in these assets. The three types of risk in an equity portfolio are specific company risk, sector/industry risk, and overall market risk. Broad-based ETFs, such as the SPDR S&P 500 (SPY) or the iShares Russell 2000 Index (IWM) provide diversification, which provides protection from company and sector risk; however, like most diversified portfolios or funds, these instruments still have market risk which seems to be increasing given the extremely high correlation of the financial markets. In order to remove the market risk to our core portfolio of broad-based ETFs, we use longer-term put options to provide price protection and have this protection in place at all times. The put options remove a substantial amount of the downside risk of owning the ETFs and provide an absolute dollar amount of risk. The price protection has a cost, and we offset the cost of this insurance with shorter-term covered-call writing on the ETF. The options act as a hedge to smooth the volatility of the ETFs and provide for a much more stable return.

### **2. For what type of investor is this strategy optimal?**

This strategy is practical for any equity investment that cannot tolerate the volatility the market has shown in the past decade. It allows an investment to be established with a maximum amount of risk prior to a correction so the tough decisions after a correction is under way can be avoided. This is optimal for any investment for which safety of principal is a primary goal. Institutional investors who manage pensions and endowments that cannot tolerate large draw-downs or any individuals having timeframe suitability issues are ideal candidates. In this uncertain fixed-income environment, many individual investors are overallocating to equities, and this strategy is ideal for those funds because of the lower risk.

### **3. Given the lack of a benchmark and relative novelty of a managed ETF portfolio strategy, when do you see this approach becoming mainstream in the investing space?**

The lack of a benchmark and the relative novelty of this strategy creates two main problems: One, because there is no benchmark, this risk profile is not normally presented to a client as an alternative in most asset-allocation models regardless of the risk and financial profile. The second problem is that investors most in need of decreased volatility and limited loss features tend to be very low-risk investors. Simply put, low-risk investors are not initially drawn to strategies using options unless they have relatively extensive experience with the option product. However, despite these problems, the majority of investors are rapidly becoming option literate with the advancement of trading platforms that incorporate options directly into them and the accessibility of quality option education. Professional as well as individual investors are becoming aware that one of the highest and best uses of the option product is a risk-management device for their equity portfolios. Armed with this knowledge, investors are increasingly looking for managers to incorporate these risk-management tools into their investment strategies, especially in the current volatile investment climate.

### **4. What are the risks associated with this strategy that investors might not otherwise see in other portions of their portfolio?**

This strategy is a long-market strategy and therefore has dollar risk to the downside. When the put options are extremely cheap, the total risk (when the positions are established) could be as low as 7%- 8%, and when the options are very expensive, it could be double that amount. As time passes and more call premium is sold to offset the cost of the price insurance, the total risk will decrease. In falling markets, investors perform substantially better than other long-only investments and, therefore, having lost substantially less, have more investment choices to make on any recovery. Unfortunately, investors must realize that this is a hedged portfolio, and it will underperform in very quick upward movements in the market. Additionally, the return, though positive, will not match unhedged long-only positions on these sudden moves upward.

### **5. What short-term market opportunities are you currently seeing for investors?**

The current market uncertainty has resulted in options becoming considerably more expensive, and this is creating opportunities for investors as the insurance that they own is becoming more valuable. This also provides much more flexibility in the covered calls allowing for more choices in terms of when to sell and how far out of the money to sell, resulting in more upside potential. The negative tone to the market, and, more importantly, the potential for further corrections given the outstanding issues of the day, certainly is a favorable environment for any new investments to be made with a protected strategy.

Liana Madura is an assistant site editor with Morningstar.com