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Options and Market fall

In his Others Views piece on Nov. 24 (The darker side of options pricing theory), Bruce I. Jacobs gave a complex subject the serious treatment it deserves. But he may have left the impression that the growth in options trading volume somehow contributed to the Oct. 27 market tumble.

While this is a popular notion in certain quarters, there is not evidence to support it. In fact, the relative calm in the options market on that tumultuous day - there was no big upward spike in volume - indicates that using equity options as a sensible way to stabilize and hedge a portfolio has caught on with

large numbers of intelligent investors.

This is a far cry from 1987, when so-called portfolio insurance had traders selling into a rapidly falling market, exacerbating the crash. This time around, those who used options as a kind of insurance sat tight and rejected panic.

This is very encouraging to those of us who have expended much effort to educate the investing public. The Options Industry Council's free seminars all around the country, the Web site at www.optionscentral.com, all the programs of the American Stock Exchange, the Chicago Board of Options Exchange,

the Pacific Exchange and the Philadelphia Stock Exchange, where listed options are traded, have paid off. Professionals and other sophisticated investors, the kind of people who read Pensions & Investments, have learned a lot in 10 years.

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Options can destabilize

Paul Stevens, president of the Options Industry Council, makes the point that options may be less inherently destabilizing to underlying markets than alternative strategies such as portfolio insurance (Letters to the Editor, Jan. 12). This is because investors who insure their portfolios by buying options do not have to sell equities or equity futures at times of market decline, as did portfolio insurers in 1987.

What is true for option buyers, however, is not necessarily true for option sellers. The exigencies of option trading are such that option sellers may have to engage in trend-following, dynamic hedging in spot and derivatives markets. In effect, option sellers may at times (and not infrequently) behave exactly as portfolio insurers behaved in the 1980s.

Exchange market makers and OTC dealers who provide market liquidity by buying and selling options expose themselves to unlimited market risk when they sell options (either puts or calls). They will thus try to hedge this risk as quickly as possible. Ideally, they will be able to find a speculator willing to take on the short option position they have assumed. But option market-makers and dealers overall will be able to do so only when the public's desire to sell options is in rough equilibrium with its desire to buy them. This is not always (or even usually) the case.

In the absence of sufficient selling interest from the public, market-makers and dealers may attempt to hedge their short positions by buy-

ing options. But OTC dealers who have sold tailored options with specifications unavailable in listed markets may find they cannot synthesize an offsetting position using exchange-traded options. Furthermore, dealers and market-makers may find buying options is uneconomical in market environments in which the public displays a marked preference for buying over selling.

When equity option traders cannot offset the risk of holding short option positions by either laying the positions off to speculators or buying options against them, they will have to hedge in equity futures and, possibly, stock markets. Such hedging demands buying as equity prices rise and selling as equity prices fall, exacerbating market trends. Furthermore, the nature of these trades is often unknown to other market participants, who are encouraged to trade with the hedgers or discouraged from taking the other side of hedgers trades, further exaggerating price movements.

An overall increase in spot market volatility may lead to an increase in option volume, as investors seek hedges to protect portfolio values. An increase in option volume, however, also has the potential to increase volatility in the spot and futures markets, to the extent that it necessitates trend-following, dynamic hedging by option dealers and market-makers. In fact, the Dec. 22, 1997, Wall Street Journal reported that the large price decline and near-record volume in the stock market

on the preceding Friday reflected not only the symptoms of the Asian flu, but also hedging by option dealers, as well as trading associated with option expirations.

When option sellers hedge with trend-following trades in the stock and futures markets, they increase volatility and the potential for price discontinuities. In this case, option buyers have in effect shifted the risk to equity market participants, who, unlike speculators, are probably unaware of the extent of the risk they are being asked to bear.

The educational efforts of the Options Industry Council are to be applauded. The darker side of options pricing theory (Others Views, Nov. 24, 1997) aims to extend the educational effort to alert the public to the potential effects of option-related trading on stock and derivatives markets.

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