Options: Ignore at Your Own Risk

Exchange-traded options and futures have found their place in mainstream investing. Investors who wish to disregard this risk being left behind. Today’s investor relies on the options market beyond its original purpose of hedging.

There has been tremendous growth and opportunity in the exchange-traded futures and options market. Commodity, index and interest rate options have all benefited from the accelerating migration toward a transparent, liquid, electronic and centrally cleared marketplace.

Millions of options trade everyday with values in billions of notional dollars. Trillions of dollars of open interest exist as investors create hedging, overwriting and yield enhancement strategies. Many investors are even replacing traditional exposures by using options. Investors must be cognizant of what is happening in options and futures because of their impact on the underlying products they represent. There are even times when the options market has deeper public liquidity than the underlying cash market.

Transacting in listed options products has never been easier. With this increased ease of access, the CME, CBOE and other exchanges are making product education a priority, resulting in the highest number of participants the exchanges have ever seen—more knowledge of the products begets more volume that begets more liquidity.

For example, commodity options traditionally traded OTC. Listed options on commodity futures have seen significant swells in flows as hedgers and speculators avoid taking counterparty risk and demand better price transparency found on exchanges. Figure 1 below shows the marked increase in option notional traded in four of the biggest commodity futures products.

Another exciting theme we are seeing across several exchanges is the significant increase of electronic trading, as shown in Figure 2. Technology is a major catalyst in the increased activity of listed options. Investors are tapping into liquidity on exchanges through electronic connections and online brokerage platforms. Today, open outcry trading pits exist in only a handful of products and nearly all of them offer parallel electronic access.

Last month, the CME, which is home to some of the most actively traded indices, interest rates, foreign exchange and commodity options, saw 86% of its volume trade electronically across all products.

Coincidentally, the Kansas City Board of Trade, founded in 1856, rang the bell for its final day of open outcry trading on June 28. The CME acquired the exchange and shifted trading from open outcry to an electronic format. Midwest wheat farmers who hedge their crops with
futures and options will enjoy the benefit of global electronic liquidity, allowing them to manage business risk more effectively. This is a financial innovation with positive economic impact.

Figure 1: Three-month moving averages of traded option notional values. The values for crude oil include both WTI and Brent options from the CME and ICE exchanges.

Figure 2: Annual electronic execution as a percentage of overall order flow of various CME products. CME commodity futures (and options) include the energy, metals, softs and grains, seeds and livestock groups.
The migration to electronic trading is not new but is accelerating in products that historically were routed manually through open outcry pits or OTC negotiations. This is particularly important for the commodity space, which is seeing the strongest year-over-year growth.

Option-related strategies will become a bigger part of the asset allocation process. Whether investors seek alternative beta exposure, pure alpha strategies, yield enhancement or hedging programs, the listed-options market covers all the bases.

Options and futures play a leading role in financial innovation that cannot be underestimated. Being fluent in these products is required to evolve within the industry and stay competitive.
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