

Tales from the Front

How Advisors Successfully Use Options in
Their Practices

“What’s the best way to learn about options? Find a mentor. Getting advice from somebody who has already done it is a great place to start. Otherwise you’re going to end up learning a number of things the hard way. **”**

In last year’s national study of options usage among advisors, we found that advisors who used options in their clients’ portfolios had larger, more successful practices. We also learned that many advisors would like to add options to their practice, but don’t know how or where to begin.

For advisors who want to add or expand their use of options, The Options Industry Council (OIC) identified ten advisors who have been successfully using options in their practices and interviewed them on how they do it. We found that they shared similarities both in how they viewed their practices and how they went about introducing and managing options with their clients. We also learned why they use options, how they talk about options with their clients, and how they fit options into their busy schedules.

This “Tales from the Front” whitepaper has the highlights of those interviews. You’ll find many ideas you can use in your own practices and, if you aren’t already convinced that options make sense for you, some good reasons to consider them.

OUR “MENTORS” AND THEIR APPROACH TO OPTIONS

In assembling our panel we invited male and female advisors to participate and included advisors from large wirehouse firms as well as regional and independent firms. Some of the advisors have been using options for several years, and others have instituted them only in the last few. On average they have 15 plus years in the business and \$500 million in AUM, though that includes some very large books, one over a billion, and a few books under \$100 million.

Some are using options in most or all of their client accounts while others told us the percentage was closer to one-third or one half. Most of the advisors charge around 1.25%. Those that covered the client’s transaction fees of course charged more than those that passed the fee through to the client. Here are the advisors that we interviewed:

ADVISOR	FIRM
Michael Cavanaugh	RCM Wealth Advisors
Charles Day, CIMA	Morgan Stanley
Dan Moskowitz, CFP	Chatham Wealth Management
Frank McCannon III, CFP, CIMA	UBS Private Wealth Management
Sander Read	Lyons Wealth Management
Stefan Rosuck	LPL Financial / Intelligent Investment Strategies
Laura Swift	Quad Cities Investment Group
T. Paul Treuting, CRPC	Ameriprise Financial
Thomas Tyndorf	Credit Suisse
Donna Walton, AIF	Morgan Keegan and Co., Inc. / Raymond James

Although the advisors with whom we spoke were very diverse, we found they were similar in three ways. First, almost all the advisors we interviewed either called themselves “risk managers” or identified risk management as a primary task.

“When we have a conversation with a prospective client, what we try to impart is that our job is to be a risk manager first.”

“The real crux of it is risk management, and then the potential of enhancing income. We look at the risk management first...”

“Our team’s approach is very old-fashioned, in that all of our client relationships begin with financial planning. And that process mitigates risk right away, because we’re not committing client capital to risk when it doesn’t belong at risk.”

With risk management as a concentration, it makes sense that these advisors would use hedging strategies, and that their clients will expect them to suggest these types of tactics. Clients, who might otherwise respond skeptically to the suggestion of options, might be more open to them, knowing the advisor is recommending them for risk management purposes.

Second, all of the advisors said that at some point they had to take the time and commit to learning about options, whether it was by reading articles or books or participating in classes and webinars. They also spoke about the importance of continuing this education, staying current with whatever new options products or strategies were introduced.

“The more I learned, the more I realized what I didn’t know...And the more I realized what I didn’t know the more I had to find out.”

“Options are something that I think needs repetitive training. You have to hear the concept, and then go and practice the strategy.”

“Initially I needed help understanding the trading platform; how much I needed to purchase and how to put the orders in. I guess I’ve always been a student of options so I’ve researched them online and attended webinars. Last year I went to the Wealth Manager Summit OIC hosted in New Orleans.”

Third, most of the advisors emphasized the importance of finding ways to add value to the services they offered their clients.

“It’s just one more thing I do to add value...one more way to make money for my client.”

“I think the sum of it is options are another arrow in my quiver, another way I can be of value.”

“People perceive us as having a different, more well-rounded or deeper expertise.”

WHY THEY USE OPTIONS AND THE STRATEGIES THEY FAVOR

Although risk management was the leading reason advisors used options, several other reasons came up in the course of the interviews; enhanced income, portfolio diversification, reduced volatility, and a way to move clients off the sidelines.

"From an income standpoint, especially in this environment, the things I can do for clients with options, nothing else can touch."

"We have a large number of executive clients who had the largest proportion of their net worth in one listed security; we'll use call writing as a way to scale out of that position over time."

"In writing covered calls and writing them in a disciplined way you lower the volatility of the portfolio. That's my other goal."

"We had a lot of clients who were on the sidelines with cash, new prospects with cash, and they were leery about getting into the market. But if we told them we could get them into the market and hedge some of that downside risk, they were much more apt to come on board."

All of the advisors interviewed use covered call writing, where a call option is written against an equal amount of stock. The premium provides additional income, although the stock can be called away if the strike price is reached.

"We primarily sell covered calls. That is the easiest strategy to explain to clients and it's the one that we use more than any other."

Buying puts or selling cash-secured puts were also mentioned by several advisors. Buying a put helps to protect the value of a stock in the case of decline. In the case of selling a cash-secured put, the put seller sets aside the cash needed to purchase the underlying shares at the strike price if assigned, but keeps the premium for selling the option if not assigned.

"We do some purchasing of puts for hedging purposes, to protect larger positions. We sell puts in some clients' portfolios that are very aggressive. When we do that the clients must be very comfortable owning the stock at that certain price."

Collars are a popular strategy, often used to protect a single stock position. In a collar, a written call and a long put are taken against a long stock position. The options may have the same strike price or different strike prices and the expiration months may or may not be the same.

"The collar strategy usually gets people's attention because it's a unique solution that isn't offered everywhere. Let's say you have a prospect that's had a million dollar single stock position for 15 years.

Everyone else is asking him if he is ready to sell and you can say "You can keep your stock. We're going to trade around your position with the goal of hedging against market crashes in an effort to make premium above and beyond the dividend."

Occasionally these advisors implement spreads. A spread is any strategy composed of two or more legs, one long option and one short option, of differing strikes on the same underlying.

"We do covered calls, hedge puts, collars, and then, personally and with one client, we'll do spreads. He's a slightly more aggressive investor, and—I opened my big mouth. When he found out I was doing it for myself he was fairly adamant about doing it for him too. I was very reluctant but, so far, so good."

A variation on spreads is the horizontal spread which usually means the purchase of a farther-term option (call or put) and the writing of an equal number of nearer-term options of the same type and strike price.

"We're using mostly horizontal spreads...which is buying the back month and then selling the front month against it, which makes it horizontal. That's how floor traders generally trade, and that's how we've evolved our strategy. We use horizontals because it has the least amount of margin requirement. It also has generally the best win-loss ratio... And there's mispricing, generally, between long dated and short dated options. There's also a time value erosion benefit when you own the long and sell the short. So that's that in a nutshell."

At least one advisor in the group also uses LEAPS, (Long-term Equity Anticipation Securities) LEAPS are calls and puts with expirations as long as thirty-six months.

"I use covered calls, protective puts and long call LEAPS. With the volatility in some of the LEAP options I felt there was the potential to generate above-average returns for a portion of some of my clients' monies."

WHAT CAUSED THEM TO ADD OPTIONS (THE AHA! MOMENT)

Over half of the advisors we spoke with could pinpoint the moment they decided to start using options. For some it was the market crash in 2007-2009.

"My aha! moment? That would be when the market crashed. I would literally wake up my wife with my kicking because I was so worried about my clients. I had been using options based strategies for my biggest clients and after watching what was happening, with hedge funds in particular, I decided that options were right for all of my clients, not just the bigger ones."

"When I got into this business was I using options or even considering them? No, absolutely not. My aha! moment was probably in '08, early 2009, when there was so much volatility in the market and we were looking for a strategy to take advantage of that volatility and boost client return because that was a struggle back then."

Other advisors told us there just came a point when it all made sense.

"I guess my aha! moment was realizing there wasn't anybody out there doing it. One day I wondered, 'Why would anybody buy mutual funds when you could create a portfolio, and then use options to hedge the risk of the downside and help finance the cost of the puts by selling calls?'"

"As far as an aha! moment? I didn't have one, I don't get emotional around investments because they don't always love me back. But I guess a mini aha! moment was realizing options had the potential to generate above, average returns for a portion of some of my clients' monies."

For some of the panelists, using options was a realization that came to them over time.

"You know, it was more of a kind of an evolution, where we kept looking for ways to gain an edge in the market and we came to the conclusion that one relatively easy way was via options around core positions."

"It was just one more thing to do to add value. In a managed account we can do it without paying commissions, which is even better."

HOW DID THEY GET STARTED

There doesn't appear to be one right way for an advisor to get started with options, though a majority of the panelists had used options in their own accounts before using them with clients. Often it seemed that it was a case of preparation meeting opportunity. They had decided to use options, had taken the time and effort to learn what they needed to know, and then either market dictates or client needs led to the implementation.

About OIC

The Options Industry Council (OIC) was created as an industry cooperative to increase the awareness, knowledge and responsible use of exchange-listed options among retail investors, their financial advisors and institutional investors. Options are a versatile but complex product, and that is why OIC hosts options seminars, webcasts and podcasts, distributes literature, and maintains a website and Investor Services live help desk – all focused on options education.

OIC was formed in 1992. Today, its sponsors include the U.S. options exchanges and OCC. OIC's Roundtable is the independent governing body of the Council and includes representatives from the exchanges, member brokerage firms and OCC. These organizations have one goal in mind: to provide a financially sound and efficient marketplace where investors can hedge investment risk and find new opportunities for profiting from market participation.

"In the downturn in '07, I actually did a lot of put selling, I said 'Look, you want to own this blue-chip stock but you're afraid to buy it. If you were paid a certain amount to buy it and that lowered your cost basis if you owned it, would that be agreeable to you?' It was a passive way to get into the equity market."

"I had a client who wanted additional income over dividend yields and I said 'Well, are you willing to give up a little of the upside in exchange for extra income?' And in his case the answer was yes, so that was the first road down to covered calls."

Typically, the advisors used options with their more knowledgeable clients first, who may already have been familiar with the concept of options, or could more easily understand them. In a couple of cases the clients

themselves asked about options.

"I started using options personally around 1995, before I became a financial advisor which was in January 1998. I used covered call writing that first year of being in the business with a handful of clients who at that time were individual-equity oriented. And, in the case of a couple of my clients, they were knowledgeable and had already been doing covered call writing."

We had clients that said 'Hey, take a look at my portfolio. Are there any stocks that it makes sense to write some calls on?' So we took the list to our options desk and said, hey, here's what we're trying to do; we're looking to generate some income, the client's modestly bullish or modestly bearish on the position whatever it may be, and we came up with a strategy. We went back to the client and boom, we're done."

THEIR TYPICAL OPTIONS CLIENT

The majority of the advisors that we interviewed did see certain commonalities among the clients with which they use options. Many of the advisors said their clients that used options tended to be among their more knowledgeable or sophisticated clients, who presumably could better understand the complexities of options. These clients could better tolerate volatility, and a loss.

"We first started using them in our client's portfolios that were more market-savvy."

"They're high net worth clients or they're very aggressive clients who do not mind having a loss. That would be my client base for which options have been offered, they have to really understand the markets. I have not offered them to a single client who I felt was a novice investor."

My top clients, my high net worth clients, the ones that I perceived would want some sort of differentiation and could also handle any extra volatility within their portfolios. Those are the ones I used it with."

Also, some said that professionals, who are accustomed to turning to other professionals for advice, were good candidates, as were entrepreneurs or small business owners, who are more comfortable with risk. Often these clients also have a desire to preserve the wealth they have accumulated.

"...successful professionals or executives of large companies, doctors, dentists, pilots, engineers. Also

small business owners, a landscaper, construction company owner, truck driving company owner, you know, guys that own successful businesses that are saying 'Hey, I want to enhance my stock portfolio.'"

"There's a do-it-yourself, entrepreneur flavor to options. It attracts those people who have that small business outlook."

"Well, if you look at our clients overall, they have typically assets with us in the \$20-50 million range, so they're all successful business owners, corporate executives, family officers, whatever it may be. They are, for the most part, not looking to find a stock that goes from \$10 to \$150 but they're looking to preserve their wealth and generate income."

In addition to characteristics that would be somewhat easy to identify like a client's financial sophistication or career history, advisors noted some intangibles, like being open minded, or having a high level of trust in the advisor. And it was pointed out by more than one advisor that the most important factor in the profile was that the client could benefit from the options strategy.

"I think it just comes down to finding people who are open-minded."

"I think it comes down to their trust in us and our ability to tell them that this product is a cheaper, easier way to protect your assets on the downside. I don't think our clients are all that sophisticated, I guess they're as sophisticated as any, but I think they trust us to do the right thing, and I think in many cases options were the right thing for these people.

"We use options with any client where we feel it is an appropriate strategy for their situation."

HOW THEY TALK TO CLIENTS ABOUT OPTIONS

Almost every advisor we spoke with started out by saying that every client is different, and so they speak with each client based on his or her perspective.

"One of the things that makes our team successful is that we are able to explain complex financial concepts to people in terms they understand based on things we know about them in their lives."

"I try to relate to the client's personal life as much as possible, and explain to them an option in terms of what they do."

That said, there are themes that came out. For example some of the advisors avoid the word “options” at least initially, so that the client listens to the concept and doesn’t just react to the word.

“I feel that the words ‘options’ and ‘derivatives’ are very scary to a lot of people. If we as advisors allow the discussion to stop there then we’re missing opportunities. I think advisors need to understand, and in turn explain to their clients, that sometimes options strategies are less risky than outright owning the stock, the mutual fund or the ETF. And they need to understand that there are strategies where you can literally sit down with your client and say, ‘OK, this is what you could lose, and this is what you could gain. They’re bookends. In this strategy there is limited loss and limited gain. Are you comfortable with that?’”

“Sometimes it’s better not to use the word options. We have a game on my team that we play called ‘take the labels off’ where we’ll be routinely introducing product without the name, or asset class or what category it belongs to. We’ll say, ‘Here are the characteristics of this investment—here’s the return profile, here’s the risk profile,’ without naming it. Because no matter how intelligent a person is, we all have preconceived notions about things. So I’ll describe the concept and the client goes ‘Wow, that’s really interesting, that sounds like a neat idea, why don’t we try that.’ And I’ll say ‘Great, here’s the options paperwork.’ And the client says, “What?!!” So, if you call it options right away, people might think speculation which is ironic since the concept behind listed options was to mitigate risk.”

Advisors often use analogies when explaining options to clients. Buying puts is similar to buying insurance, selling covered calls is compared with owning and then renting that property, and the concept of an option losing value over time can be similar to any asset that depreciates over its lifetime.

“There are some people for whom options seems to be a dirty word. And for some of those people we are able to overcome that stigma, and for others we aren’t. We talk to them in terms of buying insurance. We say, ‘we hope you don’t have a car accident, we hope a hurricane doesn’t come and knock down your house, but you need to have insurance and you’re gonna pay that premium every year whether you use it or not. Now, to deal with options in our strategy is to buy the insurance when it’s cheap. When it’s expensive, we don’t see much of an advantage to buying that insurance.’”

“The insurance analogy is the best. The only thing I’d add is that since this is my specialty, I’ll get you that insurance for as little money as possible.”

“I compare covered calls to rental property. ‘You own a property then, rent it out for income and give the renter the option to buy that property from you for a certain price in the future.’”

“Most people can sell most products pretty easily but it takes a pretty smart guy to sell what we do. I use analogies a lot. Here’s an example—when you buy a new car and you drive it off the lot, it immediately begins to depreciate and eventually it’s worthless and it ends up in a junkyard. That’s the same thing when you buy an option, it’s constantly depreciating until it expires.”

While the initial client conversation may be the most difficult, a few advisors pointed out that the conversation is likely to be ongoing. Clients come back with questions about the strategy and the advisor has to be prepared to deal with them.

“One of the challenges with clients owning options is that a lot of our performance-reporting software will not show the history of owning an option on a specific position over time. So we may meet with a client who says, ‘my Deere position is down in value,’ and we may say ‘yes, that’s absolutely true. But let’s look at the history of the options written on this position’. And then we actually show them that even though they’re down in value in that position, this is their overall return on that position. That’s a challenge, but it’s something important to do, to remind our clients and help them to understand why we’re using these strategies, and how the strategy has worked over time.

“Just the other day, I had a client who said, ‘I want to talk to you because I know you say what we’re doing is less risky, but all of my friends say that options are too risky. My CPA tells me options are too risky.’ I looked at her and I said I have to ask you just one question, ‘When they say that, do you ask them why? Because options can be risky but they can also massively lower risk so if people say that to you, you need to ask them why?’ They all get it at that point.”

HOW THEY MAKE TIME FOR OPTIONS

All of the advisors we interviewed acknowledged that including options in their practice took time. The greatest investment was at the beginning when they were bringing clients on board with the concept, understanding how the back office operated, and determining the strategies they would employ.

Over time it got easier. At least half of the advisors had a partner who shared the responsibilities, or someone on their staff who handled the back office, or did the initial options screening. Some turned to their options desk for help. All agreed that whatever the time and effort, it was worth it.

"Selling the idea of options is hard, but it can be worth it and like many things, once you become more knowledgeable and know what you're doing it does become easier. But there's no question that there's a hurdle in getting yourself up and over and really, the purpose of this white paper is to say here's how to make things easier or here's why it's worth the trouble to do it."

"I think it's important that we find the time. Yes, we're all busy, but if it's something that's going to help the client why not take the time to do it, or hire somebody for your firm to do. If you think it's something that your clients should own, aren't you doing them a disservice by not having that option available to them?"

"I'm not certain that if I was in this by myself I could do the investment plus the planning and management. I don't think that I could in good conscience have as high a percentage of my practice using options without being on a team. If you find the right tools out there too, that's incredibly helpful."

"It helps to have the right business model. I think having the ability of using discretionary fee-based accounts is the greatest operational leverage there is for us. If we can get in and out of one stock in a day, we can do 200,000 shares of stock in 200 accounts in a minute and not have to make 200 phone calls to get 200 clients to say yes or no."

"Well that's the thing, it isn't easy. At the beginning it's hard, because you do have to do the calculations, you do have to go out and search for the best strike prices or whatever, and then you have to think about each individual client and what makes sense for them and their tax situation and which accounts, so no, it's not easy, but it's the right thing to do. And when you're doing the right thing for your client, that's fun."

HOW OPTIONS HAVE BENEFITED THEIR PRACTICES

Asked how options had benefited their practices almost all the advisors said it had helped differentiate them in the marketplace, strengthen client relationships and attract business. With so many high net worth clients

having multiple advisor relationships (a recent Cerulli study found 70% have relationships with more than one advisor), the need for differentiation has never been greater.

"I need to stand out to clients and add value and have an interesting and different strategy that's not the firm's discretionary model that the firm is running for all the advisors. I want to go out and build my business with high net worth individuals who are much more astute investors but who do not necessarily want more risk. I think this is the strategy that will make me look different from the average broker."

"I feel like I am an extremely specialized individual, in a world of commoditization, which is to me investment management. That's what I was taught: buy some mutual funds, charge a 1% fee, rebalance them annually, re-allocate, modern portfolio theory, blah blah blah. That's what they teach everybody. Through options, and the stock market, I have decided that I no longer believe in asset allocation and that I don't believe in modern portfolio theory. I do to a degree, but when push comes to shove, when there's stress on the system, everything can fail."

"I think options give you a more unique value message. Let's say you have a high net worth prospect who is evaluating advisors, and you are the advisor that is comfortable with options. Maybe you're just really comfortable with one strategy. But if you're that person, you would set yourself apart."

"Options weren't a strategy that was available in the firm that I transferred from. Now that I've moved I can differentiate myself by offering them. I can go back to the same clients and say, 'hey, by the way, all the things I was doing before I can still do, but here are some things that I couldn't do before that I can do now.'"

In the past, advisors have said they were concerned about putting client relationships at risk if they offered options, but many of the advisors we interviewed said using options strategies in their clients' portfolios had actually strengthened their relationships.

"It does change the client relationship and it helps us to help our clients. I think that clients are relieved to know that their advisor is willing to look for whatever strategies may help in any given environment. It's not that they are necessarily looking at their returns and saying 'yes, I'm doing better than I would if my advisor were not using options. But more I think the feeling is

“wow, that is awesome, you were thinking outside of the box, to try to find strategies that will work in difficult times.”

“All I can say is we have a very, very high percentage of clients where we know we have all of their business. I can’t say it’s just because we use options, but I can say that I think it has to do with our willingness to look and evaluate any strategies that may help them. I think the fact that we use them shows our clients that we’re actively managing their investments and we’re being proactive. It sets us apart and I think that’s what clients are looking for, someone who realizes that we’re not in 2000 anymore or even 2008 anymore. They want somebody who’s proactive and will learn strategies that add value.”

Offering options strategies as part of a comprehensive wealth management service can separate an advisor from the competition. It not only helps make the advisor a more attractive choice and generates referrals, but enables the advisor to be the chooser—going after the client with whom they want to work.

“We actually have a referral program and do a quarterly marketing piece where we let the people providing the referrals know what’s working and what’s not working. We have told them that the options story is working, so when they have a client who is reticent about getting into the market, but needs to at least keep up with inflation, those leads typically come to us.”

“When you come along with a product like this—let’s say you meet someone who has a couple of million dollars in a single stock position. Sometimes they’re lone wolves, but other times they know a whole bunch of people with the same stock position, so this can be a book-building

product. In my case I had one guy with \$3 million in UPS stock, and he referred me to \$150 million of his buddies. So it became an amazing way to grow the business and if you’re in prospecting, which most FAs are, it’s a great way to prospect.”

“I think the risk management story and the use of options allows an individual advisor to target the clients he really wants to go after.”

THE LAST WORD

Despite what has been a challenging period, the advisors who participated in our panel all seemed confident. Most had seen their practices grow significantly in recent years. All spoke with enthusiasm about the direction their practices were going and encouragingly about the benefits of adding options to a practice.

“I think the most important thing for advisors to do is take the time to understand all the pros and cons, the risks and rewards, of every different option strategy. I use collars a lot, and there are pros and cons to using the collar. The con is, I’m restricting a client’s upside and the client may not want a restricted upside. So you have to understand the strategy that you’re using, and you need to go to some classes. OIC has some really good classes, you can pretty much learn anything online, and through books—you know 14 years later I still buy books on options. I watch OPTIONS ACTION every Friday.”

“I’m thrilled that everybody’s not doing options because it sets me apart but for the life of me, I don’t understand how everybody in my business doesn’t manage risk by using options. I don’t know what they’re thinking.”

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