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EUROPEAN ETF OPTIONS

AN OPPORTUNITY

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INTRODUCTION

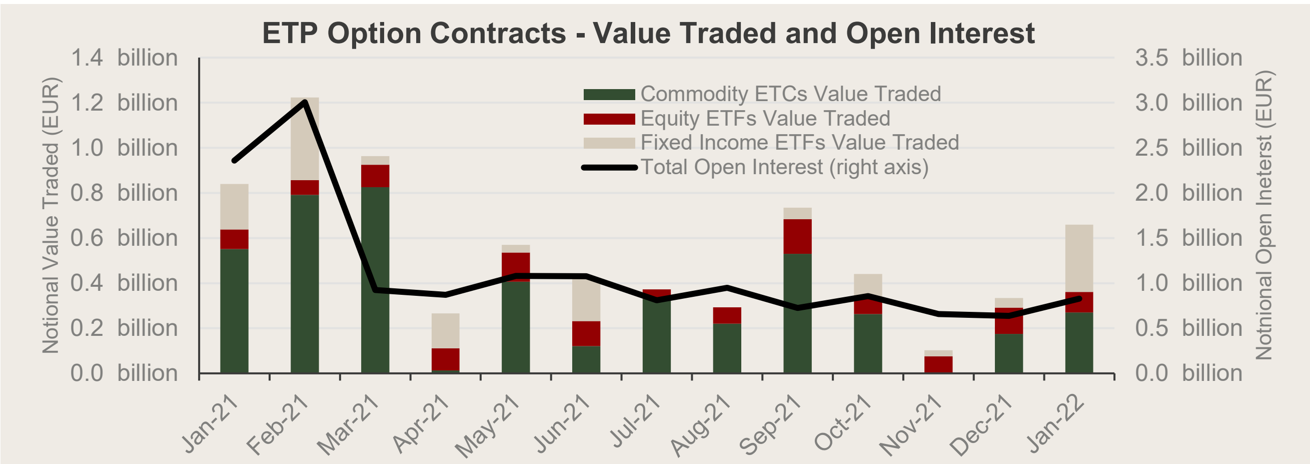
The versatility of the ETF structure has always been one of its greatest strengths and this is no less true when it comes to options markets. Put and call options on ETFs (and more broadly, ETPs) in Europe have received far less attention than what their ingenuity and usefulness would suggest. As financial markets move into a new regime of higher rates with spikes in volatility more likely, ETP options can be a very valuable tool for investors looking to achieve specific investment outcomes or to manage risk. Below we introduce some of our key strategies that we have used for clients of our options advisory service.

THE LANDSCAPE

The European ETP options landscape consists of options on 23 equity ETFs, 6 fixed income ETFs and 9 exchange traded commodities – from four ETP issuers (iShares, Xtrackers, WisdomTree and a gold ETC from Deutsche Börse). The options landscape is distinct from ETFs which have an embedded options strategy, such as the increasingly popular Global X NASDAQ 100 Covered Call ETF.

With a notional open interest on listed ETP options of over EUR 830 million at the end of January 2022, investors have only just begun to utilise this opportunity in Europe. This open interest, while far from a perfect measure of product adoption, is dwarfed by notional open interest of over EUR 1.2 trillion on listed European equity index options. ETP options in the United States are also significantly more popular and liquid with notional open interest on SPY (SPDR S&P 500 ETF Trust) alone being over USD 680 billion (December 2020). In Europe, the key reason for the relative insignificance of ETP options is largely legacy in nature, but there several differences between index and ETP options:

- Liquidity (index options are generally more liquid than ETP options);
- Settlement (index options are cash settled, ETP options are physically settled);
- Exercise (index options are European-style, exercisable on expiry, while ETP options are a mix of European-style and American-style, exercisable at any time before expiry);
- Dividends (some ETFs pay dividends and this may prompt early exercise by the option holder to receive the dividend if it is larger than the remaining time value of the option).

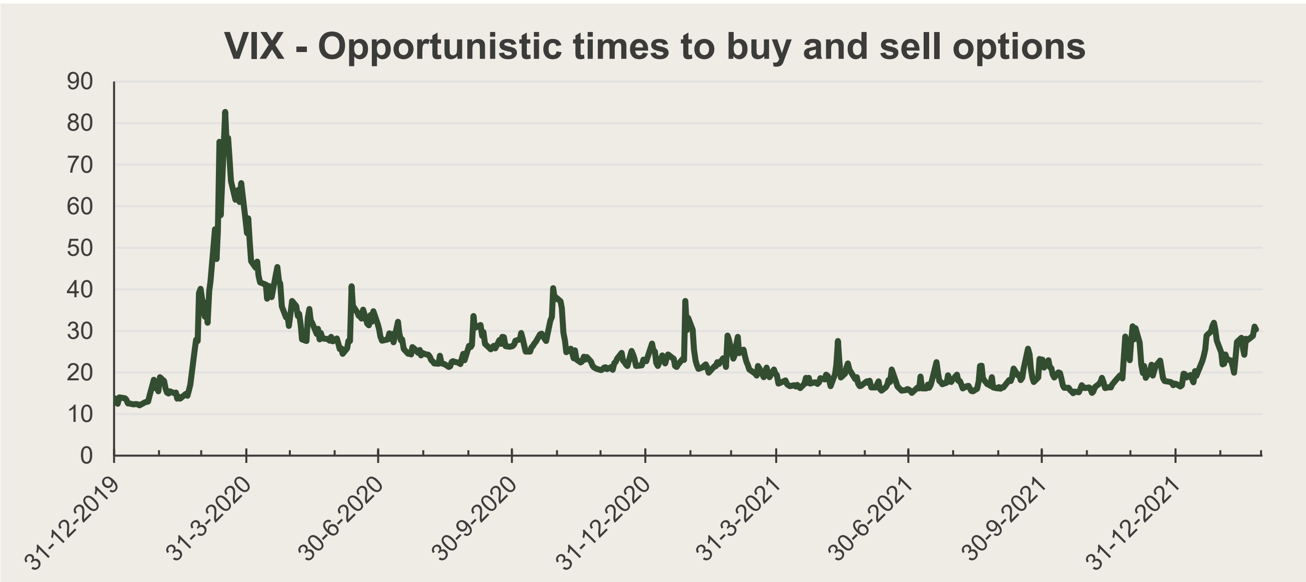


Source: Eurex

BENEFITS AND OPTION STRATEGIES

The physical settlement of ETP options can be an important benefit as this can help reduce both execution risk and trading costs on date of exercise of the option. Assuming investors wants to receive (or deliver) an ETP, physical settlement may be preferable to cash settlement which then requires an extra trade to purchase (or sell) the ETP itself which comes with trading costs (bid-offer spreads and brokerage) and execution risk that the trade may not executed at the desired time or price. Physical settlement may work well in a cash covered put writing strategy where an investor sells out-the-money put options generating a premium but has a desire to own the ETP at a lower price. If the ETP price falls, the investor is put into the ETP (physically settled) as cash held in the investor's account is automatically used to fund the exercise (purchase). From a behavioural perspective implementing a cash covered put writing strategy removes the emotional aspects of having to decide to buy the underlying ETP when markets fall as the investor is forced to exercise. It thus also requires the investor to be comfortable owning the underlying exposure represented by the ETP.

The opportunistic use of the cash covered put writing strategy can yield very respectable premiums, especially when the writing of the options coincides with a spike in volatility – which have been frequent and relatively large in magnitude as seen in the VIX chart below. With a view of continued spikes in volatility – not least driven by geo-politics and reserve bank rhetoric – this may remain an attractive strategy. Covered call writing on long ETP positions, generating extra income, is another useful strategy for ETP options although physical settlement may trigger tax consequences if the existing position has unrealised gains and needs to be delivered. There are many other useful option strategies, some more suited to physical settlement, although they all require careful risk management.



Source: Cboe

Another benefit is that ETP options can allow for investment strategies to be more accurately implemented. An investment strategy, such as hedging, can be most accurately implemented when using a derivative on the exact same underlying instrument. For example, when hedging exposure to fixed income ETFs using credit default swaps it may be less effective than using an ETF option on the exact same underlying ETF (with the same index and the same risks).

CHALLENGES

While the current selection of ETP options in Europe is largely based on some of the more established ETPs, but ETPs can and do change over time. They may track a new index (we have seen a flurry of ETFs changing to track equivalent ESG indices), the index itself may change its methodology (the DAX® index went from tracking 30 to 40 of the largest companies in Germany in September 2021) or other changes may arise.

While ETP options volumes in Europe are relatively low, US ETF options markets are currently telling several interesting stories, some of which are also showing up in European markets. Put option open interest on US corporate investment grade and high yield are at near all-time highs, which is unsurprising given negative market views on duration and widening credit spreads.

One of the biggest challenges that ETP options face in Europe is their relative lack of liquidity. The simplicity and transparency of options listed on Eurex, for example, is appealing but on-screen liquidity can often appear poor (i.e. wide bid-offer spreads). Therefore, as with trading ETPs themselves, better execution might be achieved using Request for Quote. This critical conversation about liquidity is no different (and no less important) than it is with the execution of ETPs themselves. Prices and volume as seen on order books are not representative of true liquidity. With a proliferation of different strike prices and expiry dates, it is common to have no open interest across parts of the option chain in European ETP options.

Another key challenge is the limited range of ETPs on which there are options, but this goes hand-in-hand with investor demand, and it is something that we hope will broaden as adoption of ETPs and ETP options improves.

CONCLUSION

ETP options in Europe, while currently largely under the radar, present investors with an interesting opportunity to help achieve their investment risk and return objectives. They have their challenges, principally around liquidity and breath of available underlying ETPs, but the unique non-linear payoff profile of options and their physical settlement (meaning reduced execution risk and trading costs on exercise) allows them to be very effective instruments for portfolio construction and risk management.

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