Generations ETFs episode 5: Hans Albrecht and Nicolas Piquard, The Options Guys, interview transcript, recorded February 4, 2015

Introduction
Welcome to Generation ETFs, brought to you by Horizons ETFs Management Canada Inc. This is a podcast series dedicated to the next generation of investing. I'm your host Donna Papacosta, and in this series, Generation ETFs will aim to educate and inspire investors to understand and be active in their portfolios by discussing market trends and investment strategies with the leading experts in the industry.

In this episode of Generation ETFs, you'll meet The Options Guys. That's Hans Albrecht and Nicolas Piquard. Hans is vice president, portfolio manager and options strategist with Horizons EFTs Management Canada Inc. He co-manages a number of products in Horizons ETFs' growing global line-up of ETFs and oversees day-to-day options activities. Nick is vice president, portfolio manager and options strategist with Horizons ETFs Management Canada Inc. He works closely with the investment management team to oversee the day-to-day options activities of Horizons ETFs' line-up of covered call ETFs.

Together, we call Hans Albrecht and Nicolas Piquard The Options Guys. In this conversation, they demystify options to some extent, and discuss options terminology that might confuse people. Nick and Hans also talk about some of the advantages of trading options within an ETF rather than on your own.

Donna: Hans, for some investors options sound like a scary thing. In the simplest terms, can you explain what an option is.

Hans: Options at their very core are actually simple instruments. They're sort of part of this bigger world of derivatives, but listed options are quite simple to understand. You can buy or sell a call or a put. We like to use the put example as an easy-to-understand example because it acts a bit like insurance. If you buy a put on Apple, for example, you have the right to sell 100 shares per contract up to a certain date. Options generally offer many different expiry dates, strike prices and so, depending on your investment thesis, there's a fair bit of flexibility in how you want to target your trade.

A call example would be sort of the opposite of that. A call gives you the right to purchase a stock at a certain price up to a certain date. You can also sell calls and puts, in which case you would receive a premium that was paid by the buyer. For that premium, you ultimately have the obligation to potentially deliver the stock by expiry if it goes to the strike price. We do things like that and strategies like covered calls and we use put buying in equity-protect type strategies.

Nick: I think one of the reasons investors think that options are scary is because there's so many of them. You have so many strikes. You have so many expiries. It's hard to know which one to look at. Then you see all the news headlines with derivatives losses. I think a lot of the problem is with education and I think that the number-one thing investors should do is go to ... There's a lot of resources on the Internet where you can learn about options and learn about investing in options and it'll simplify things quite a bit.

Donna: Nick, that sounds straightforward, so why doesn't the average investor use them? Can you give us some insights?

Nick: As I mentioned, there's been a lot of derivatives losses and people get scared. I think one of the problems is, with all the losses that you hear about maybe in the headlines in 2008 and various other times, is that options allow you to use leverage, but the leverage is what gets you in trouble. Options themselves, you can use them in a non-levered way, which doesn't incur the losses that you hear about in the newspapers.

You can think about it as a kitchen knife. You can have a very sharp knife and if you don't use it properly you can really hurt yourself with it, but if used properly it can be a very useful tool. If you talk to chefs, they would much rather have a sharp knife than a dull knife.

Hans: Without a doubt, Nick, you're right. Options can absolutely be used for speculation and I think that's where some people get into a little bit of trouble. The more traditional ways that they're used and particularly as a way to enhance existing equity holdings. In the case of covered calls or protected puts, these are some of the most simple ways and very conservative ways that you can use options as an advantage in your portfolio.

Nick: Furthermore, I just want to mention this as a resource, a lot of the derivatives exchanges such as Montreal Derivative Exchange or the Chicago Exchange, they have resources online where you can learn about options. They offer seminars for financial advisors and investors. They're generally free. You can just sign up and go to see them and learn a lot about the strategies that you can use.

Donna: Hans, volatility has become a popular word since the 2008 market crash. For options traders, volatility is important and often beneficial. Why is that?

Hans: There are two kinds of volatility that we like to talk about in the options space. There is actual volatility, which is the volatility that we've been observing. It's movement that we've seen in markets.

The second kind of volatility, which is one of the most important things that option traders need to focus on, is implied volatility. That's the relative price that people are paying for options. Option pricing is really sort of a reflection of sentiment and so the price can be based on many things, expectations, supply and demand, emotion. They're very much a reflection of what people *think* could happen.

If I can use the example of insurance again, a similarly priced home in Toronto might cost $1,000 to insure. The same home in Florida could cost $2,000 to insure. Same value of home and the difference is there's an elevated perhaps risk of hurricane risk, of storm damage in Florida. For that risk, the insurance company has to charge you a little bit more for that insurance. The difference there in those two prices is really implied volatility.

A stock like Tesla might have high implied volatility. They're expecting greater movement in that stock than perhaps something like GM. When we look at these things and we look at volatility as a way that reflects emotion, we can take advantage of that. We can monetize that. When people are excessively worried about the market, there are things we can do. When they're a little bit more complacent, as they were last summer, there are things that we can do in that case.

Nick: From an options trader’s perspective, generally they like volatility. If you think of volatility going up and down as the stock going up and down, the more volatility you see the more trading opportunities there are for an options trader. He can position himself, buy low and then sell higher. When there's no volatility, it's not great for the option trader. He really can't make much money because there's not that many opportunities to buy and sell. But when there's a lot of volatility, there's definitely a lot more of those opportunities.

Hans: That reminds me, Nick, that an important point with volatility is that its mean reverting. What that means is volatility tends to come back to sort of an average level over time. So, an equity can go anywhere and it can stay there. People get a little bit excited and that's reflected in option pricing. Ultimately they calm down, option pricing comes down. Likewise, when people are a little bit too complacent, ultimately over time volatility tends to make its way back up to sort of an average, so to speak.

That concept of mean reversion is really integral to trading options. You have to really realize where are we within that range. Are people very excited? Are they worried? Are they perhaps not worried enough? Therein lies some of the advantages for profitable opportunities.

Donna: Nick, you write for a blog, The Options Guys. What's the goal of your blog?

Nick: I think the goal of the blog is to give our readers the option trader’s perspective on the financial markets. I think there are plenty of blogs out there with various perspectives. You hear about blogs on that with value investors or with growth investors. There are quantitative investors out there. People look at credit. We look at volatility and we look at options pricing. I think that all of these different ways of slicing the pie are valuable. What we try to do is we try to give our view of the markets given what the volatility environment is and what the options are.

Hans: Yeah. One of the great things about options is you can overlay an option strategy to an existing equity strategy. We like to talk about things that we're seeing, macro things, micro things, and then perhaps delve a little more deeply and figure out is there an easier way to do this? Is there an easier way to take advantage of the thesis or an idea through options? Maybe you can have an idea that can play out in a less expensive way through using an option strategy. We try to apply that volatility knowledge, that option knowledge to our views of things in general. Hopefully we can add a lot of value that way.

Donna: Let's talk a little bit about terminology. What is the difference between in the money, at the money, and out of the money options?

Hans: An in the money option, call option, has a strike price that's lower than where the stock is trading. It has some intrinsic value, meaning an in the money American option should always be worth at least what its intrinsic value is. An option that, for example, is $3 in the money will be worth at least $3. An in the money option will move a little bit more closely with the stock up and down versus an out of the money option because it has a higher likelihood of remaining in the money by expiry.

An out of the money option has a strike that's higher than where the stock is trading. If you buy that option, you're betting that the stock is going to move towards that strike by expiry. It's going to cost a little bit less than an in the money option because it has a lesser likelihood of being in the money by expiry, so that of course has to be reflected in the price.

An at the money option has a strike that's right around where the stock is trading, so it has an equal chance of being in the money or out of the money by expiry. It doesn't have any intrinsic value, but it has a high time value. It's kind of at the cusp of being in the money.

One thing worth noting is the behaviour of an option price is not linear. An out of the money option costs less, but it's going to move more slowly in relation to the stock. The opposite goes for an in the money option; it's going to move quite a bit more like the stock because it's in the money.

Donna: Nick, you and Hans operate in the institutional options world in your capacity at Horizons ETFs. How is that different to what I might experience with my own account or with my financial advisor?

Nick: The options market is ... There's the liquidity that you see on the board, but there's also the liquidity that you don't see on the board that happens with institutions. You see that in the stock market where you'll see what they call block trades. Where you have a buyer and a seller and they're matched up by brokers who are dealing with institutions and they put a big block of stock on the exchange.

This happens in the options world as well where a buyer calls and a seller calls, they agree on a price and they match that price on the exchange. What happens is a lot of that liquidity is only amongst the institutional investors and you don't really see that on the actual exchange in the bid and offering. That allows institutional managers to relatively get some more liquidity and sometimes better pricing as well. That is one of the advantages institutions have.

The other thing I want to mention is there's also an over-the-counter market where these are private contracts that are traded between institutions. There's also quite a bit of liquidity there. At our funds, we only trade the listed options because we like the transparency, but there's also a lot of liquidity that affects the pricing in those over the counter products.

Hans: Yes, Nick, you talk about liquidity and that's really a key, particularly in the Canadian market. There's visible liquidity, which you can see on the board; you can see the bid and the offer. There's also hidden liquidity in our market. Part of our job is to uncover that hidden liquidity and we do that through our relationships with the dealers that we trade with. That's an important factor when trying to get better fills, particularly of a larger size, which we normally trade in.

Donna: Nick, here's a question we ask everyone in this podcast series. What is the best piece of investing advice that you've ever received?

Nick: The best piece of investing advice I've ever received is always do your own homework. Not only is it the best advice I've received but I would definitely extend that to anyone who's listening. This is particularly true when trading options.

It's easy to take advice from other people: “Why don't you do this, why don't you do that?” When trading options, but when trading anything or when investing anything, you really have to be comfortable with the positions that you're trading or investing in. If you don't have that psychological comfort and if you haven't done your homework, you're not going to be able to see the trade through properly, you're not going to be able to trade it properly if you haven't done your own homework.

I really encourage people to learn about options, understand them before they trade them because that's when people get into trouble.

Donna: What about you, Hans?

Hans: I would say a lot of the time I tell people to, when they're trading a long option, so buying puts or calls, I always tell them give yourself enough time. We always have to bear in mind that options are instruments that have a limited lifespan. There's nothing more frustrating than being right on an idea but having your options expire before it plays out.

People are always lured by these super cheap premiums. They see a 10 cent call or 10 cent put and they think, well you know, I could make a fortune if the stock does what I think it's going to do. A lot of the time you'll end up just losing that 10 cents.

So, spend the same amount that you were going to spend, perhaps buy fewer contracts, and give yourself some time. Buy a two- or three-month option. Give yourself a chance to be a little bit wrong in the short term, but you'll do better over time. You'll see your confidence start to rise as you give yourself a chance to be right and not feel the pressure from feeling like you have to be right immediately.

Nick: I think that's a good point, Hans. One of the things about options is they lose their value relatively quickly as the expiry approaches. Even though you're spending more money up front when you're buying those longer-dated options, if the stock move that you're hoping for happens within the next month it's not going to matter. A lot of that time value that you pay for the option is still going to be in the option and you're going to make money anyway. Absolutely I agree with Hans here. I think timing is everything.

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