Hedging With Options

By Greg Crosby, ASC Secondary Marketing Product Manager

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Option Contracts are the least used, most abused arrow in a risk manager's quiver. For many successful risk managers in the mortgage banking industry they wouldn't hedge a portfolio without them. Others wouldn't touch them.

Options have a variety of uses. They are tools for arbitrage, trading, yield enhancement or risk transfer. Options can be obtained through Broker/Dealers or Commodity Exchanges. Call Options give you the right to purchase (or assume a long position) in the underlying instrument upon which the call option is targeted. Put Options give you the right to sell or assume a short position in the underlying instrument upon which the put option is targeted.

The holder or buyer of an option has (theoretically) unlimited profit potential and limited loss potential. The loss is limited to the amount (premium) paid for the option. The reverse is true for the writer or seller of the option.

You may either exercise an option. For a call option this means you would either own (or assume a long position) in the underlying security at the options designated strike price. Otherwise you can either sell back your option position or allow it to expire.

Options are wasting (or decaying) assets. They contain terms that define when they will expire. Option markets may be either liquid or illiquid. Options traded in liquid markets lend themselves well to the use of pricing engines (models) to determine the value given a specific price for the underlying instrument and point in time in the future.

Illiquid options do not. They are best judged upon the merit of how much intrinsic value they will have at your target price. Intrinsic Value for a Call Option = Target Price – Strike Price or 0, whichever is greater. Intrinsic Value for a Put Option = Strike Price – Target Price or 0, whichever is greater.

Options traded on regulated exchanges such as the Chicago Board of Trade (CBT) or the Chicago Mercantile Exchange (CME) tend to be liquid markets due to the fact there are a number of willing buyers and sellers both on the auction floor and outside at any given time and indications of the immediate liquidation value of the option tends to be posted through a number of quotation services. This is not always the case though.

Options purchased from Broker/Dealers tend to be less liquid since the only trading partner you have for the option you purchased is the Broker / Dealer.

The level of liquidity alone does not define whether an option is beneficial to you as a hedger. It only changes the way in which it is best to analyze the option.

There are a number of option pricing models in use. All require the use of a computational device, handheld calculator or computer. Most of these models return a cadre of statistics in addition to solving for price. These statistics are often called "The Greeks". Various letters of the Greek alphabet are used to describe various attributes about the expected dynamics of the option. This is typically where many people put their hands over their ears, close their eyes tightly, turn around slowly and chant "There's no place like home, there's no place like home".

The good news for you is that in 2003 you don't have to suffer that same fate. The Greeks were initially made available to floor traders in an era when mobile computing was not available so scrolls were handed to traders periodically during the day so that they could slide rule themselves into a tizzy.

The more advanced mortgage banking risk management software today forecasts the (cost) or benefit of the option position. This P/L impact is merged with the rest of the mortgage pipeline's profit sensitivity. Now the focus is upon managing performance, not stirring the alphabet soup.

We will talk more next time on how different hedging strategies benefit when options are measured and implemented appropriately and how some common hedging snafus can be minimized.