Fresh Invest: What are our options?
Season 2, Episode 9 Transcript

Alex Lieberman, Co-founder and Executive Chairman of Morning Brew Hey, there. I'm Alex Lieberman, co-founder and executive chairman of Morning Brew. This is season two of Fresh Invest, the investing podcast sponsored by Fidelity Investments and powered by Morning Brew. Today, we're talking about options, a financial instrument that you've probably heard of, but you may not be entirely sure how they work. Today's conversation will fill in any of those gaps.

Alex I'm excited about this topic because talking about options is a great way to review investing basics, which you can never do too often while exploring an asset class that's really unique. Options are contracts that mean the holder can, but is not required to, buy or sell a certain amount of an underlying asset. Because of that structure, the fact that an option is an asset that's tethered to another asset, they fall under the umbrella of derivatives.

Alex Options are often used to do things like hedging, speculating, diversifying and, of course, plain old generating income. They're also sometimes used as a tool to help manage risk—another concept that's pretty central to the whole idea of investing. So let's dive in with our guest from Fidelity, Greg Stevens.

Alex Greg, welcome to the show.

Greg Stevens, Fidelity Hey, thanks, Alex. Excited to be here!

Alex So, let's just start with some basics. Could you introduce yourself and explain what you do at Fidelity?

Greg Yeah, of course. So, I'm Greg Stevens. I've been at Fidelity for over 15 years and in the industry, hard to say this, but for [chuckles] over 25 now.

Alex Wow.

Greg Prior to Fidelity, I spent some time at the CBOE, or the Chicago Board Options Exchange, obviously located in Chicago. But at Fidelity, I work within our independent investing group as a team or a squad leader for the options experience.

Alex Awesome. Well, I actually passed the CBOE last month when I was in Chicago.

Alex So, just to get us started on options, could you briefly explain what they are and the benefit they can offer to investors?

Greg Yeah, of course. Well, you know, you mentioned this early on, but options are contracts. They give buyers rights, sellers obligations, to either buy or sell the underlying security at a specific price over a specific period of time. Buyers pay a premium for that right. Sellers receive the premium to take on that obligation.

Greg I think the most important thing options do is give investors choices. With stocks, you can only do a couple of things. Buy it, sell it, or short it. With options, you can customize a strategy to take advantage of many different forecasts. You can be bullish, bearish, or neutral, and there's an option strategy for you. You also mentioned generating income, speculation, or even hedging. So, I think the most important thing is options give choices.

Alex Love it. So yeah, it sounds like options offer a level of flexibility of choice that potentially other assets don't. So what are the most common reasons, from an investor's perspective, that they choose to incorporate options within their portfolio?

Greg Well, there are many reasons why investors choose to incorporate options, but I think there are two common ones. Investing and income. First, let's talk investing or, as some would call it, speculation. Well, options let an investor, for a fraction of the cost, use options to invest in their bullish, bearish, or neutral market forecast.

Greg For example, an investor may like a stock trading at around $100, but they don't have, say, $10,000 to buy 100 shares of the stock. They could, however, buy a call option, which typically represents 100 shares for a fraction of that cost. Now they can use options to trade their bullish forecast.

Greg On the other side, let's talk about income. A common strategy used by investors is the cover call strategy. This involves selling a call against stock you own. Investors use this strategy to help generate income or to help improve their overall stock returns when the stock is, say, for example, in a holding pattern.

Greg So, I'm sure that sounds great to our listeners, but there are trade-offs, right? With both strategies, you must have a very defined forecast for price, time, and volatility. With price, where is it going—up or down? For time, when is the price movement going to happen, because options do expire. And with volatility, is there any event or an increase in risk that I need to plan for? I guess, you know, my point in bringing this up is that investors need to plan for both getting in and getting out. But yeah, these are the two most common strategies.

Alex Love it. So, we had speculation. We had income generation. And then there's options strategies that allow you to hopefully accomplish either of those strategies. Let's talk about just the proliferation of options as an investment strategy and as an investment tool. Per CBOE Global Markets, nine of the 10 most active call option trading days in history have occurred this year. Why do you think that is?

Greg Well, I think one of the primary reasons is awareness that options even exist as an investment. Access to those markets through brokers, and most importantly, education. But I'll tell you what, let's focus on two of those three: awareness and education. I mean, 10 years ago, and well, actually, you know, what I would say is that not even that long ago, most investors thought an option was either adding chicken or steak [chuckles] to a salad. [Alex laughs].

Greg But, you know, through social media, through education, through what brokers have to offer, options have gained a broader awareness. I mean, tune in to any related news channel, and it's hard to go 15 minutes without someone mentioning options or having a dedicated segment on options.

Greg So awareness has been a big part of driving the popularity of the product. Options no longer enjoy anonymity, for sure. But for me, it really boils down to education, education, and education. It's been the biggest driver of the popularity of options. I mean, Alex, how likely are you to trade or put your hard-earned money in something that you don't understand? My guess? Not very likely.

Alex Nope.

Greg So, you know, at Fidelity, one of our most popular option classes is the basics of options, and we offer this class most every month. It's also helped to dispel myths like options are only for gamblers or very sophisticated active traders or, you know, that options are just too risky for the average investor.

Greg While this may be how some have viewed or even [indistinct] used them in the past, now I think through education we've been able to dispel myths like these. But to me, you know, education is the primary reason that options have grown in popularity.

Alex Yeah, I think that's a huge point that you make, which is just, like, making options more approachable has allowed for them to become more mainstream. Because, you know, even speaking from experience, I remember as I got into sales and trading at Morgan Stanley prior to my career with Morning Brew, in our training, we did an options course and I went into that thinking, like, I'm going to have no idea what's going on.

Alex And I was a pretty sophisticated investor, just given what my career was going to be. But then when we went through it and I realized, like, this actually isn't that complex. It just, for whatever reason, it has this feeling of being wildly daunting.

Greg Yeah.

Alex So I think it's a huge point that you bring up. So let's talk about now that we're talking about how investors incorporate options in their portfolio, why there's been this proliferation. Would you suggest that investors think about options exposure differently than how they think about stocks in their portfolio?

Greg Well, I'll answer it this way: yes and no. So, if you have any other questions we can [indistinct] [chuckles]. I guess when I say yes or no, let me explain a little bit. With stocks, you can buy and hold. I believe the stock is going up, and since I own it, I can hold it for as long as I want. Now that's a very simplistic view of stock trading, because investors, you know, in stocks, we use fundamental and technical analysis, among other tools, to determine their strategy.

Greg But with options, and this is why it's a little bit of the no. But with options, that is a starting point. You must have a three-part forecast. Number one, for the stock. Are you bullish, bearish, or neutral? What's your price target for the stock? Number two is really timing. When is the price target for the stock going to happen? Options expire. And actually, let me say that again, options expire. With stock, you can hold the stock, you know, for an indefinite period of time, but with options, you must have a time frame.

Greg And then finally, number three: volatility. And what I mean by that is, are there any foreseen or unforeseen events that can impact the outcome of your option trade? Volatility plays a big part in your forecast, and it's important for option traders to understand.

Greg So thinking about them differently, yes, because there's a three- part forecast, and no, because you're still involved with the stock. So that's why I say yes or no.

Alex Love it. So one last question, actually from one of our listeners.

Greg Mm-hmm.

Alex What role did options trading play in the notorious GameStop frenzy that happened earlier this year?

Greg I think you'd have to go far and wide for someone not to have heard about GameStop at this point, right? So, yes, options played a part in the GameStop volatility. Investors used them to participate in GME in a number of different ways—buying calls if they thought it was going up, buying puts if they thought it was going down, among other options strategies.

Greg To try and keep this explanation simple, I would say this: Options are derivatives. You mentioned this early on, and they derive their price from the relationship to the stock's price, amongst some other variables. So while option investors were just using the options to participate in the volatility, market makers on the options exchange, when selling to a buyer a call option, you know, they will use stock — buying or selling it — to mitigate their risk for taking on the opposite side of that transaction.

Greg So one could say that options trading also drove some stock trading in that as well while market makers were trying to hedge. So, you know, however, and I will say this in closing, options played a part in the frenzy, but obviously they weren't the only factor.

Alex Would you mind just explaining one more time? Kind of this—the way that market makers reacted to GME traders buying options. I just want to make sure it's clear to listeners.

Greg Yeah. So market makers aren't interested in where the stock is going. They want to hedge, or manage, the risk of buying and selling options and making two-sided markets. So they will use the underlying stock in order to hedge, or to mitigate, risk of if I'm the buyer of a call option, well, someone has to sell that option to me. Well, if a market maker sold me that option, they may go in in order to mitigate the upside risk to this and buy an equal number of shares in order to mitigate their upside risk —

Alex Yeah.

Greg On it. So they will use stock, you know, going back and forth, buying and selling it, trying to keep that neutral market position for themselves.

Alex Got it. So just to make sure I understand this example. If a market maker was, say, selling a bunch of call options to people who were buying call options for GME, since the market maker really isn't interested in taking on the risk of potentially GameStop's price going up —

Greg Right.

Alex They would effectively, if they're selling a lot of call options, buy GameStop stock today so that they don't potentially have to buy it at a higher price in the future when those call options end up getting exercised.

Greg Yeah, that's exactly right. So the market maker just wants to be neutral on everything.

Alex Yup.

Greg They don't want to have either a bullish or bearish position, at least the majority of times.

Alex Got it. This has been an awesome introduction to options. Greg, thanks so much for joining the show.

Greg Yeah. Thanks, Alex, and thanks for having me.

Alex To everyone listening, thank you so much for again, listening to Fresh Invest. I really enjoyed this conversation. To me, options are a super-essential part of the markets for an amateur investor to understand. If you don't know at least the basics, you can miss out big time.

Alex I was also interested to hear that options are growing in popularity among both individual and institutional investors. I wonder if there's something about this broad democratization of finance we keep hearing so much about that's making options more attractive to people. Maybe once they were exclusive to big, professionally managed funds, but now anyone who can do some internet research or can listen to a great investing podcast can acquire the tools to explore options.

Alex Thanks again for listening. And make sure to tune in next week. We'll take today's option discussion and explain how you can apply the lessons to your portfolio in real life.

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