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"He who can no longer pause to wonder and stand rapt in awe, is as good as dead; his eyes are closed."
— Albert Einstein

Listed option trading has increased steadily over the past decade. Investors across the entire spectrum are adopting option products for the purposes of yield enhancement, directional and volatility strategies, and for their original purpose of hedging. One area that has garnered significant interest by both the retail and professional community are the index and ETF option products.

Figure 1 below illustrates the option volumes aggregated across all 9 exchanges using 22-day moving averages since mid-2006. The absolute number of options traded has more than tripled in the past 6 years. If we break up the data by comparing index and ETF options with equity options, also known as single-stock options, we find some interesting shifts in the market structure.

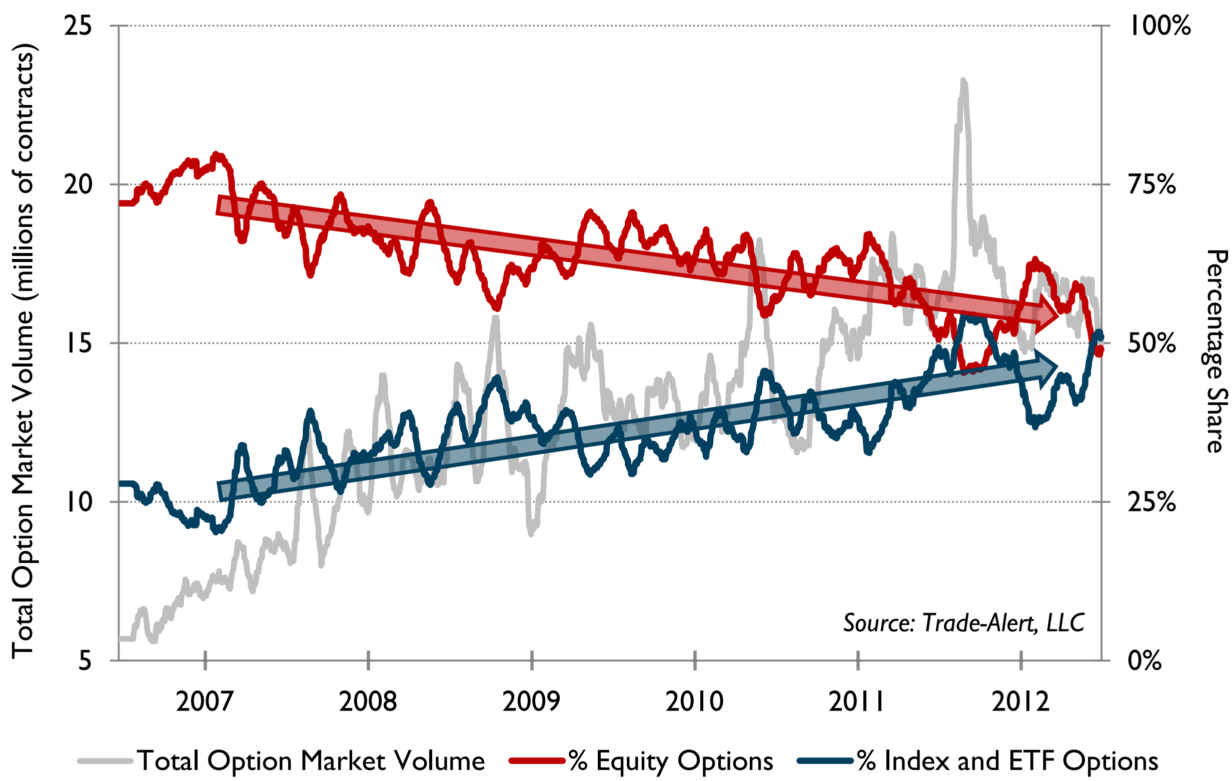

Figure 1: Total option market volume and percentage share of equity options and index and ETF options from June 2006 to June 2012. All values are 22-day moving averages.

This figure illustrates that the number of options traded on indices and ETFs has consistently gained market share. We have a few ideas about why this might be:

Liquidity and reliability:

When the world fell apart in late 2008, many different asset classes saw markets nearly shut down. We recall moments when there were no bid-ask prices for certain bonds, CDSs, and many other esoteric derivative products. Counterparty risk made trading near impossible, and short sale bans on single stocks roiled markets. One bright spot during the mayhem was the listed index and ETF option market. Investors gravitated to the S&P 500 through SPX and SPY options because liquidity remained robust. Broad-based index products continue to prove their reliability as traders navigate turbulence in global markets.

Opaque pricing in OTC products:

Investors have a very low tolerance for not knowing the true value of their positions and the risks of their portfolios. The days of timer options, correlation options and many other obtuse OTC derivatives are nearly gone. Hedge funds and asset managers relied on the counterparties that issued these products for their mark-to-model values. This created challenges because many instruments were non-standard with conflicting valuations. Keeping it simple means transacting where the greatest transparency lies: on an exchange.

Hedging demand remains:

A high correlation market makes index and ETF options more attractive for "one-stop-shopping" hedges. Listed options with varying maturities allow for trading around specific events, and it appears that there is no shortage of these events recently. Investors are using index and ETF products as a means of managing risk and are doing so with great zeal.

There is concern that listed index and ETF options could be hindered by regulation and government intervention. Recently, the TABB Group released results of interviews with buy-side traders indicating that they expect the Dodd-Frank/Volcker Rule regulations will have a negative impact on liquidity.[1] Our feeling is that new participants in the marketplace will pick up any slack in liquidity caused by the new regulations.

[1] http://www.tabbgroup.com/PublicationDetail.aspx?PublicationID=1114

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