Thinking Thematically

Why options income ate the world

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Overview

- The pandemic – and stimulus packages – brought new investors into the retail marketplace
- Meanwhile, in many developed nations, a growing population of retirees is bringing increasing focus on income-oriented investments
- Desire for income is one factor behind a growing market for options income strategies, a marketplace that has ballooned since 2020 and is worthy of consideration

It's 2020. You're sitting at home. You've just eaten your third all-bean dinner in a row. You're, quite rationally, debating the safety of one human being eating that many legumes. But then, as you look down at your phone, you realize – your stimulus hit. What do you do with all that money? We know now some of the things many of us chose to do: pay off debts, buy long-awaited furniture and appliances, renovate the house. In all, nearly 500 million payments went out, amounting to just over $800 billion.[1] It was a lot of money, and it went a lot of places.

While we know now that much of this money went after goods, causing inflation – some of it transitory and some of it not – goods weren't the only things people bought. Many also bought assets, chasing after investments as they sought greater financial security. So many new users created brokerage accounts, that some dubbed them "Generation Investor," finding in surveys at the time that 15% of them had never invested before 2020.[2]

So, who were these investors and what all did they buy? For one, they weren't all homogenous. It's hard to forget the meme stock bubbles driven by the likes of GameStop and AMC, though there was also demand for income-producing investments. While the retail investor boom saw more younger, first-time investors, some of them hoping to "F.I.R.E." (Financial Independence Retire Early). However, in the US – and much of the developed world – we're also seeing a growing population of income-hungry retirees join their ranks. And amongst those income-oriented investments, options income ETFs at times seemed to reign supreme, growing from barely $1B in assets in 2020 to more than $70B today.[3] In this piece, we'll explore options income: what it is, why it appeals to investors, and where it might be headed.

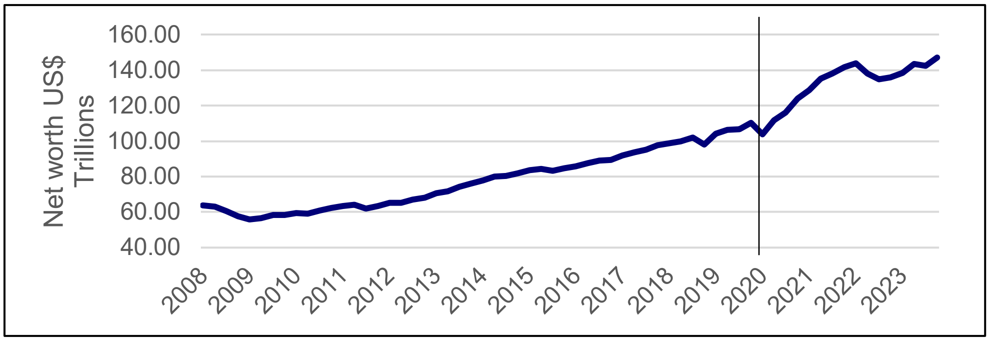
Selling volatility

There are many different types of options income strategies, though they ultimately boil down to a similar philosophy – selling contractual obligations to generate income. Calls, puts, equity-linked notes – options generally involve some bet on the market to go up or down, using pre-determined levels of upside and downside. Meanwhile, other investors demand options, using them for hedging or investing, and they generally pay a premium for the privilege. This premium changes based on the level of volatility – and becomes income to the option seller.

Of course, there are plenty of more familiar sources of income like dividend stocks and bonds. However, the income generated from options has a whole different set of sensitivities and drivers. For example, one of the primary risks associated with traditional bond exposures is interest rate risk, which has been increasingly influenced by central bank policies. Equity options avoid interest rate risk and can deliver high income regardless of the interest rate environment or the actions of the Fed. Limitations of options, however, typically involve limiting equity upside exposure.

1. US Federal Pandemic Oversight, November 2023
2. CNBC, April 2021
3. Bloomberg L.P. as of May 31, 2024
4. Federal Reserve, October 2023

Pandemic-era stimulus increased US net worth[4]



We didn't start the F.I.R.E.

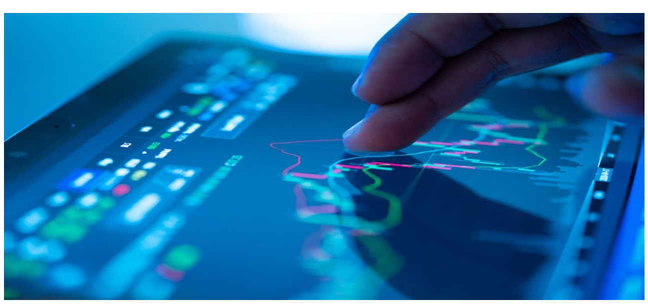
Why did options income ETFs appeal so much to this growing contingent of investors? For one, investors – especially retiring ones – still care about income. After decades of earning wages, it can be intimidating to picture retiring on one's savings. For the F.I.R.E. crew, looking to retire half a century earlier than their grandparents did, there is also a desire for passive income, finding some source of funding for daily needs without eating into principle. Options strategies could help fill the gap, potentially supplying higher income streams without some of the risks like interest rate risk/duration we discussed earlier.

Of course, there are risks to over-emphasizing income. Income often sacrifices growth, and selling options contractually obligates some capping of investment upside. However, bonds have no inherent upside – simply clipping the coupon and hoping to avoid default – while dividend-paying stocks retain full market participation but may not generate as high of yields. Dividend stocks can also introduce value biases – and even potentially value traps if the underlying companies are cheap for a reason, thereby inflating their yields.[5] Options are simply a part of the puzzle, though there seems to be a reason some analysts have taken to calling such strategies "boomer candy."[6]

Not all strategies are created equal

With many types of funds to choose from, it's helpful to remember that – just like other income-oriented investments – not all options income strategies have the same design, and there are some key factors to consider. For one, options are contracts, and they expire. This can introduce rollover risk, and each strategy takes a different approach to finding their next call or put. Some simply roll at equal thirty-day periods, though this could mean the distributions change dramatically as volatility rises and falls in the market.

Second, it's worth remembering that options are generally written over some existing equity exposure. While selling options will contractually limit the upside of those investments, what an investor buys is still important. How does it match the rest of the investor's portfolio? Is there a mismatch between the options and underlying equities? Is the equity something the investor would otherwise want to own? There are also choices in how much of the equity exposure is used, requiring choices about the overall balance of income and growth.



Where do we go from here?

There's no question that the pandemic created a paradigm shift in the retail investing market. Given the ballooning growth of options income ETFs, we're also clearly seeing a category worthy of consideration. Of course, options – like all income investments – come with their own set of specifications and trade-offs. Perhaps the trend will fade with time. Perhaps investors will stop wanting income. But for now, we're paying attention.

5. AB, March 2023
6. Bloomberg ETF IQ, March 2024

Investment Risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Investments focused in a particular industry or sector are subject to greater risk, and are more greatly impacted by market volatility, than more diversified investments.

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