

Exchange of the year, North America

Chicago Board Options Exchange



Matt Moran, CBOE

> “Developing investment products with optionality is one of the next big steps in the evolution of the financial products marketplace,” according to Matt Moran, vice-president of the Chicago Board Options Exchange (CBOE). Accordingly, CBOE – the world’s largest options marketplace and the creator of listed options – has been at the forefront of driving this development forward for the past two years.

CBOE scoops our exchange of the year award for North America thanks to the market’s successful uptake of its innovative buy-write indexes, including the CBOE S&P 500 BuyWrite Index (BXM), the CBOE Dow Jones Industrial Average BuyWrite Index (BXD) and the CBOE Nasdaq 100 BuyWrite Index (BXN).

A buy-write strategy is generally considered to be an investment strategy in which an investor buys a stock or a basket of stocks, and also writes covered call options that correspond to the stock or basket of stocks. Such strategies have an added attraction to some investors in that buy-writes can help lessen the overall volatility in many portfolios.

“Admittedly, in past years many structured products were based on stock indexes with linear payouts,” Moran says. “Looking forward, however, many investors are expected to develop more interest in products with optionality and non-linear types of payouts. Products based on derivatives-based indexes, such as the BXM, can have the potential to add income and yield, reduce volatility and risk, and provide for leverage types of exposures.”

In September 2004, Ibbotson Associates, a US consulting firm, issued a case study on the investment strategy represented by the BXM to assess risk-adjusted performance of the index, to evaluate the role of this covered-call strategy in a portfolio and to establish if an investor can implement the strategy. Encouragingly, the study found that BXM has had the best risk-adjusted performance of the major domestic and international equity-based indexes over the past 16 years. And since the

study was released more than 40 products, using the CBOE’s buy-write strategy, have come to representing a market value of around \$20 billion, Moran says.

Structured products heavyweight Morgan Stanley was the first to distribute a CBOE buy-write strategy note in March 2005 with the launch of its 8% Targeted Income Strategic Total Return Securities which were exchangeable for a cash amount based on the BXM index. Morgan Stanley has, to date, raised a total of \$500 million in deals linked to overwriting strategies with a \$350 million raised by the Targeted Income issue. Merrill Lynch has offered similar products, as has Citigroup.

The CBOE has also licensed the BXM to Boston-based Rampart Investment Management, which is marketing the strategy mainly to institutional investors.

The exchange has also been busy in other related areas, Moran notes. In February 2006, for example, the CBOE started to list options on the CBOE S&P 500 Volatility Index (VIX). VIX is the widely disseminated benchmark index commonly referred to as the market’s ‘fear gauge’, Moran says, allowing investors to make options trades based purely on their expectations of volatility.

“The VIX and BXM indexes have attracted a significant amount of interest,” Moran says, for examples, a Goldman Sachs representative has been a proponent of an out-of-the-money (OTM) buy-write strategy and so in March 2006 we introduced the CBOE S&P 5–2% PTM BuyWrite Index (BXY).”

Although the BXY uses the same methodology as the BXM, it is calculated using out-of-the-money S&P 500 Index (SPX) call options, rather than at-the-money SPX call options. The BXY strategy diversifies the buy-write opportunities currently provided by the BXM, Moran says, and it yields lower monthly premiums in return for a greater participation in the upside moves of the S&P 500.

Why they won

The buy-write strategy has been used by portfolio advisers and wealth managers for over a decade, but the CBOE has packaged the concept into a structured product format that reduces transaction costs and provides an automated, buy-and-hold method of adding the strategy to portfolios. The CBOE buy-write index products have seen impressive uptake by a number of major structured product issuers.