GLOBAL X ETFs RESEARCH

Managing Event-Driven Risk: Alternatives to 0DTE Options

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Topic: Covered Calls & Options

Related ETFs

Please click below for fund holdings and important performance information.

QCLR – Global X Nasdaq 100 Collar 95-110 ETF

XCLR – Global X S&P 500 Collar 95-110 ETF

QTR – Global X Nasdaq 100 Tail Risk ETF

XTR – Global X S&P 500 Tail Risk ETF

Fifty years ago, the Chicago Board of Trade developed the first modern options exchange, the Chicago Board Options Exchange (Cboe). In the years since its launch in 1973, options strategies have become increasingly comprehensive, giving investors opportunities to implement combinations of option type, strike, and expiration as factors into their portfolios. The heightened level of flexibility has promoted the use of options to address a wide array of risk factors. Most recently, instruments like 0DTE options and derivative-based ETFs have stepped into the limelight as opportunities to address event-driven risks.

Key Takeaways

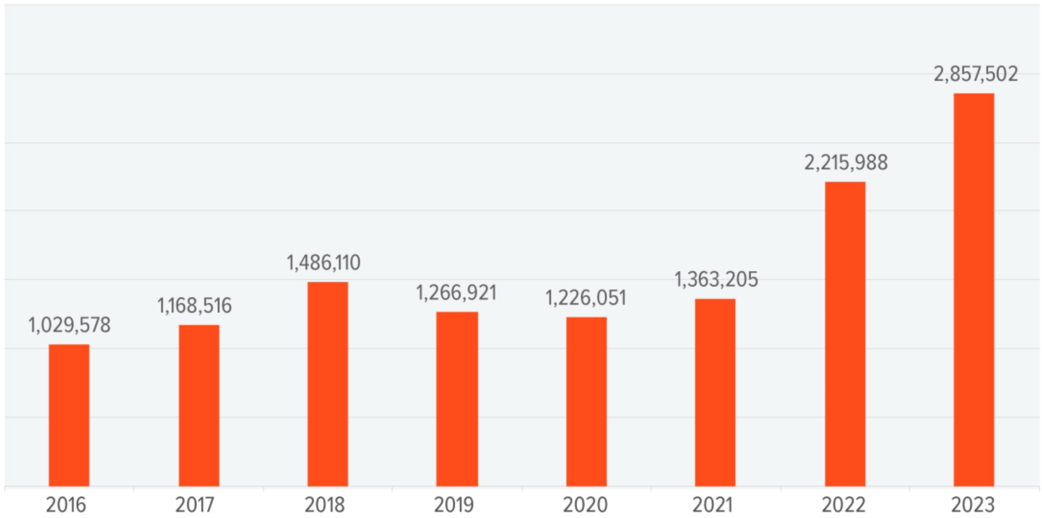
- Portfolio administrators are often required to manage a broad scope of risk factors. Traditional diversification may help mitigate specific concerns, but purchasing option contracts might represent a more effective approach by which to deal with event-driven market moves.
- Options with zero days until expiration, dubbed 0DTEs, have a relatively short track record within the space. However, they are already making up more than 50% of daily options trading volume on the S&P 500[1], with investors harnessing their low cost in an effort to hedge against daily price swings.
- Passive option strategies utilized within the ETF structure can similarly provide a degree of protection against event-driven market declines. Global X's derivative-based product portfolio seeks to do so by incorporating longer-dated option contracts, maintaining a near-perpetual source of potential loss mitigation.

Put Options Check a Lot of Boxes for Risk-Conscious Investors

At one time or another, most investors have probably seen equity positions that they've held take a hit in response to an underwhelming earnings report. Surprise decisions by governing bodies of the monetary system are also likely to have led to some unexpected drops in stock values. And though efforts to diversify across sectors and asset classes can help provide a modicum of protection against these events, watching any position trend into the red can leave investors questioning if there was anything they could have done to prevent it.

Incorporating put options into a portfolio can provide this avenue, or at least have the potential to alleviate this sentiment. Offering flexibility and easy implementation, put options are contracts that give the purchaser the right, but not the obligation, to sell shares of an underlying security to a counterparty at a predetermined strike. These contracts can help establish a level of maximum loss potential for the purchaser, which can be particularly useful when dealing with event-driven market moves. These attributes have likely driven interest in options trading in recent years, particularly on the S&P 500 index since the 2020 pandemic.[2]

AVERAGE DAILY CONTRACT TRADING VOLUME FOR S&P 500 (SPX) OPTIONS
Sources: Bloomberg L.P. Daily SPX option volume data measured from January 1, 2016 to October 31, 2023. Retrieved November 21, 2023.



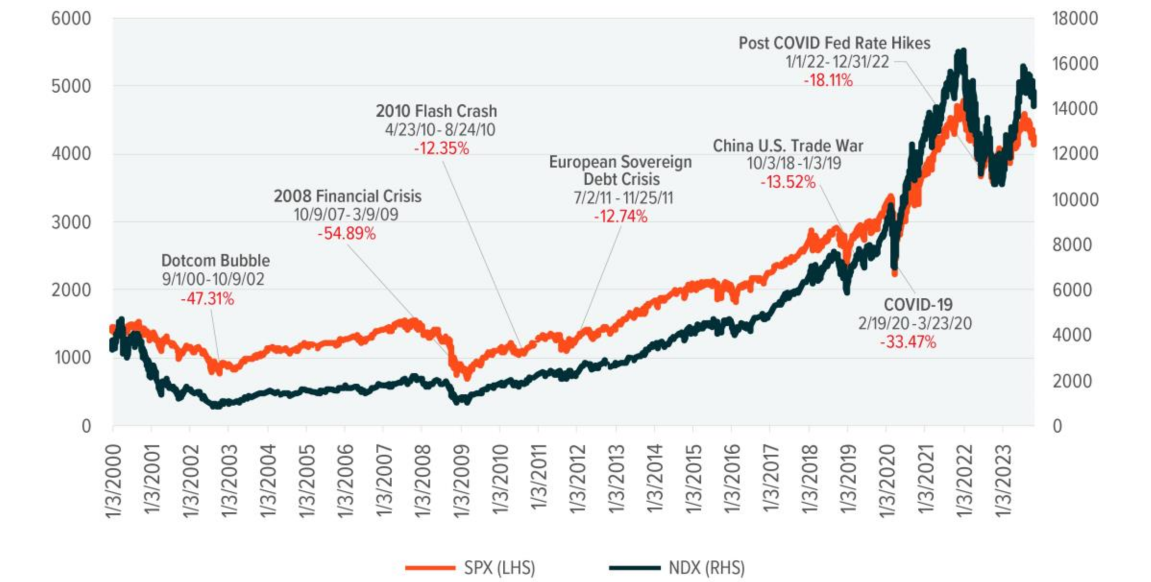
Single-Day Contracts May Address Scheduled Events, But There are Drawbacks

Index options with zero days until expiration (0DTE) have grown tremendously popular over the last couple years. Their limited time value makes them an inexpensive investment and they can provide a degree of liquidity that is necessary to enter and exit positions seamlessly. When an investor sees an important economic news release or the announcement of election results coming up on their calendar, they can simply mark the date and enter into a 0DTE put contract to limit the impact that it might have on their portfolio.

Like any other put option strategy, the funds required to create the 0DTE position (the premium paid) will reduce the price appreciation potential of the position, but at a low cost this might not seem like much of a deterrent. In fact, average SPX option bid/ask spreads recently tightened to reflect the market exhibiting softer volatility, and this made 0DTE trades on SPX options even more affordable.[3] That said, owing to their short time until expiration, 0DTE put strategies likely require investors to be more actively engaged. They must find and purchase options in a timely fashion while being cognizant of events that necessitate their use. Investors may be able to anticipate some of these underlying events, but history tells us that some of the largest drawdowns to have taken place across the broader markets were unforeseen, and their impact lasted longer than just one day.

S&P 500 AND NASDAQ 100 HISTORICAL DRAWDOWNS

Sources: Bloomberg. Data from 1/3/2000 to 10/31/2023. Retrieved November 21, 2023 from Global X Bloomberg Terminal. SPX is the S&P 500 Index. NDX is the Nasdaq 100 Index.



Passive Strategies Can Hedge Event-Driven Market Declines Too

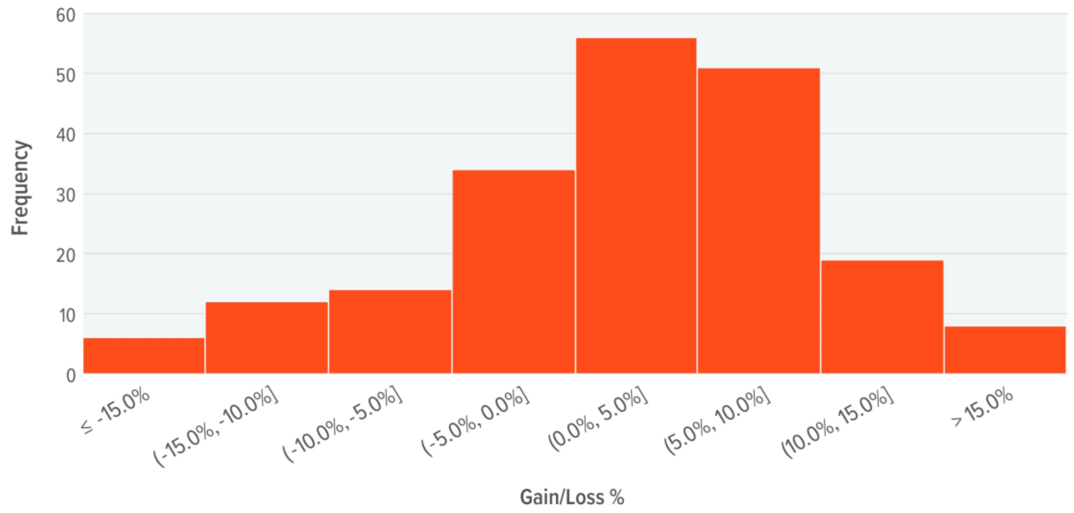
Options with zero days to expiration can mitigate event-driven risks, but investors must be able to pinpoint the right time to purchase them, evaluate their desired degree of downside protection, and implement the strategy with tact and attentiveness. That is, protective 0DTE strategies typically require active management. For investors looking for a low-cost passive investment, however, the Global X Nasdaq 100 Collar 95-110 ETF (QCLR) and the Global X S&P 500 Collar 95-110 ETF (XCLR) employ put options, as well. However, because these funds incorporate options with three-month tenors, and roll their positions on a quarterly basis, they can theoretically be held in perpetuity.

The collar 95-110 strategy features buying put options that are 5% out-of-the-money, which are partially funded by selling a 10% out-of-the-money call option. The trade-off helps keep the cost of funding the downside protection low, and it allows an investor to still reap the benefit of up to 10% upside price appreciation associated with the underlying investment over the roll period. QCLR and XCLR incorporate options that expire quarterly, and they are rolled on a quarterly basis as well. This essentially allows them to create a floor on potential losses incurred by the Nasdaq 100 and S&P 500, respectively, and that floor is reestablished from one outcome period to another.

Over the last 50 years, the S&P 500 has recorded quarterly declines of 5% or more in 16% of all cases. Meanwhile, it has recorded gains in excess of 10% in 13.5% of cases. Implementing the collar 95-110 strategy would likely help narrow the tails associated with this distribution and provide investors with less widely-oscillating price returns for their equity investments. The put options they employ would also help provide downside price mitigation for market detractors that have an impact lasting over a series of trading days.

FREQUENCY OF S&P 500 QUARTERLY PERFORMANCES OVER THE LAST 50 YEARS

Sources: Bloomberg L.P. (Data set). S&P 500 (SPX) Quarterly Price Return from December 31, 1973 to September 29, 2023. Retrieved on November 21, 2023.



Tail risk strategies can approximate similar exposure to broader equity indexes. For example, the Global X S&P 500 Tail Risk ETF (XTR) and the Global X Nasdaq 100 Tail Risk ETF (QTR) offer investors uncapped upside price appreciation potential (minus the cost of the premiums paid) and a floor against drawdowns greater than 10% from the purchase of the put to the option's expiration in three months. These funds similarly roll their options on a quarterly basis. However, because of the level of moneyness at which they seek to purchase their put options, the Global X Tail Risk ETFs' puts still come at a low cost. These funds buy put options that are 10% out of the money on a quarterly basis, and they, too, can allow investors to operate without necessarily specifically pinpointing unforeseen market moving events.

Conclusion: Passive Options Strategies Can Be Good News for Bad News

Of the many risks that investors must endure during the course of a trading day, those that are associated with news-related events can be some of the most detrimental to performance. 0DTE options can mitigate the risk of these events, but they often require an active management style, which can be challenging to maintain or implement effectively. In our view, Global X's passive index collar and tail risk derivative strategies can provide a constant source of downside mitigation while maintaining a core exposure to some of the largest domestic indices. Another important factor to consider when evaluating these strategies is that event-driven market declines may not only last for one day. It's one of the key reasons why having a rolling strategy in place can provide more seamless protection than an active 0DTE defensive strategy.

Footnotes

1. The Wall Street Journal (2023, October 17): Stock Market News, October 17, 2023.
2. Bloomberg L.P. Total Current Day Option Volume for S&P 500 (SPX) from January 4, 2016 to December 30, 2022. Date measured August 30, 2023.
3. Cboe. (2023, August 15). The Rise of SPX & 0DTE Options.

Glossary

S&P 500: Stock index that includes 500 leading U.S. companies and captures approximately 80% coverage of available market capitalization.

Nasdaq 100: Stock index that includes 100 of the largest non-financial companies listed on the stock market.

In-The-Money (ITM): An option is considered to be in-the-money when the price of its underlying asset has surpassed the strike price necessary for it to become exercisable.

At-The-Money (ATM): An option is considered to be at-the-money when the price of its underlying asset is aligned with its strike price.

Out-Of-The-Money (OTM): An option is considered to be out-of-the-money when the price of its underlying asset has not yet surpassed the strike price necessary for it to be exercisable.

Protective Put: An option strategy entailing the purchase of a put option on a security that the investor presently holds.

Tenor: The length of time remaining before an option contract expires.

Roll: A strategy employed to maintain option exposure to an underlying security wherein the investor closes out an existing position and opens a new contract with new strike price and expiration terms in the same security with the same directional bias.

Call Option: A call option is a contract that provides the purchaser the right, but not the obligation, to buy an underlying security at a pre-determined price level, provided the price of the reference asset exceeds its strike price before the call contract reaches its expiration date.

Tail Risk Strategy: An option strategy harnessing a protective put to create a floor against extreme losses.

Strike Price: The price at which an option becomes exercisable, once the price of the underlying asset moves into the money.

Moneyness: Indicates the position of the current price of an underlying asset relative to the strike price associated with an option. Often expressed as a percentage, with 100 denoting an option that is at-the-money.

Drawdown: A measure of decline from a historic peak to a trough in a period before a new peak is established.

Index returns are for illustrative purposes only and do not represent actual Fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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Investing involves risk, including the possible loss of principal. Concentration in a particular industry or sector will subject QCLR, XCLR, QTR, and XTR to loss due to adverse occurrences that may affect that industry or sector. Investors in QCLR, XCLR, QTR, and XTR should be willing to accept a high degree of volatility in the price of the fund’s shares and the possibility of significant losses.

The Funds engage in options trading. An option is a contract sold by one party to another that gives the buyer the right, but not the obligation, to buy (call) or sell (put) a stock at an agreed upon strike price within a certain period or on a specific date. By purchasing put options, in return for the payment of premiums, the Funds may be protected from a significant decline in the prices of the respective equity index if the put options become in the money; but during periods where the Index appreciates, the Fund will underperform due to the cost of the premiums paid. By selling covered call options, QCLR and XCLR limit their opportunity to profit from an increase in the price of the underlying index above the exercise price. While the fund receives premiums for writing the call options, the price it realizes from the exercise of an option could be substantially below the indices current market price. A liquid market may not exist for options held by the Funds.

QTR and QCLR are non-diversified.

Shares of ETFs are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Brokerage commissions will reduce returns.

Carefully consider the funds' investment objectives, risks, and charges and expenses before investing. This and other information can be found in the funds' full or summary prospectuses, which may be obtained at globalxetfs.com. Please read the prospectus carefully before investing.

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