Schroders solutions

Equity Derivatives Market Intelligence

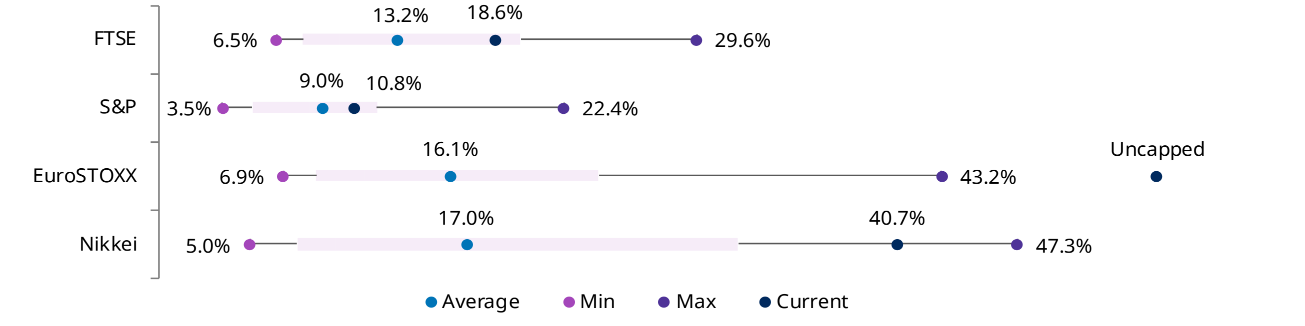
29 November 2024

Call spread collar

Equities with protection against a drop of 0% to 20% and a capped upside

The retained upside potential of the call spread collar looks attractive compared to historic levels in absolute terms, particularly for FTSE, Nikkei and EuroSTOXX structures. Notably, the upside of the EuroSTOXX structure is currently uncapped, meaning it is not necessary to sell an OTM call to achieve a net-zero cost.

Retained upside potential



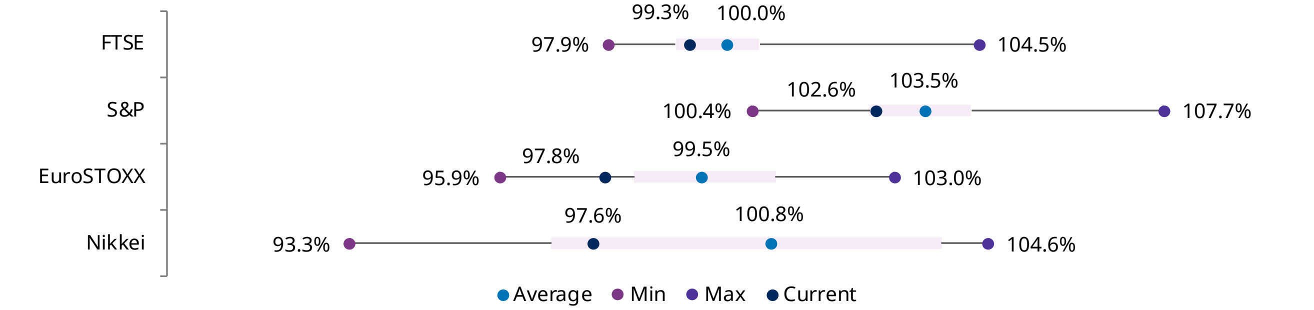
Source: Schroders, Bloomberg, 29 November 24. For illustrative purposes only. Using monthly pricing of the structures from 31 January 2016. The shaded areas of candlestick charts represent the second and the third quartile levels. The structures have one year maturity, are priced using local currency options on price return indices, and the funding is assumed to be the Sterling cash rate.

Risk reversal

Equities with protection against a drop of 0% to 10%

The current pricing is appealing as the funds generated from the sale of the 90% put, coupled with the cash are sufficient to purchase in-the-money calls. This structure has a good potential as an equity replacement.

Starting equity level for capturing upside



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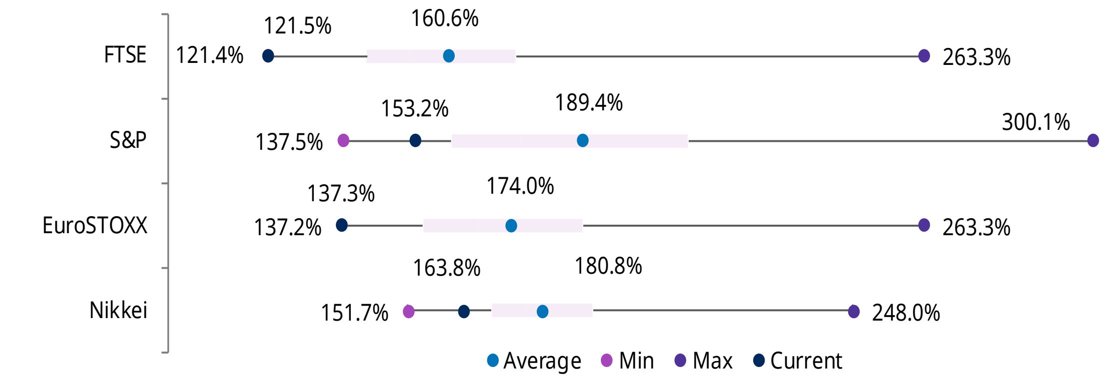
Condor

Benefit from equity markets moving sideways +/- 15%

The number of condors that can be purchased has fallen below the historical average, suggesting that it is not an optimal time to implement this structure. Of the four indices, Nikkei seems to have the highest Condor ratio amongst the four indices.



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Attribution analysis

Decomposing the monthly pricing change to three key factors

Since the start of the month, the GBP cash rate has decreased by 9 basis points, which had a negative impact on the three structures. The S&P 500 forward rate increased by 24 basis points, negatively affecting the pricing for the call spread collar and risk reversal, but positively impacting the condor structure. Additionally, there was more than a 1% decrease in volatility, resulting in a negative impact on the call spread collar and the condor structures, whilst positively impacting the risk reversal.

S&P 500	Call spread collar	Risk reversal	Condor
Current	10.8%	102.6%	153.2%
1-month change	**-1.1%**	**0.2%**	**-22.3%**
Cash rate	-0.3%	0.1%	-3.6%
Forward	-0.3%	0.3%	1.5%
Volatility	-0.5%	-0.2%	-20.3%

Source: Schroders, Bloomberg, 29 November 24. For illustrative purposes only.

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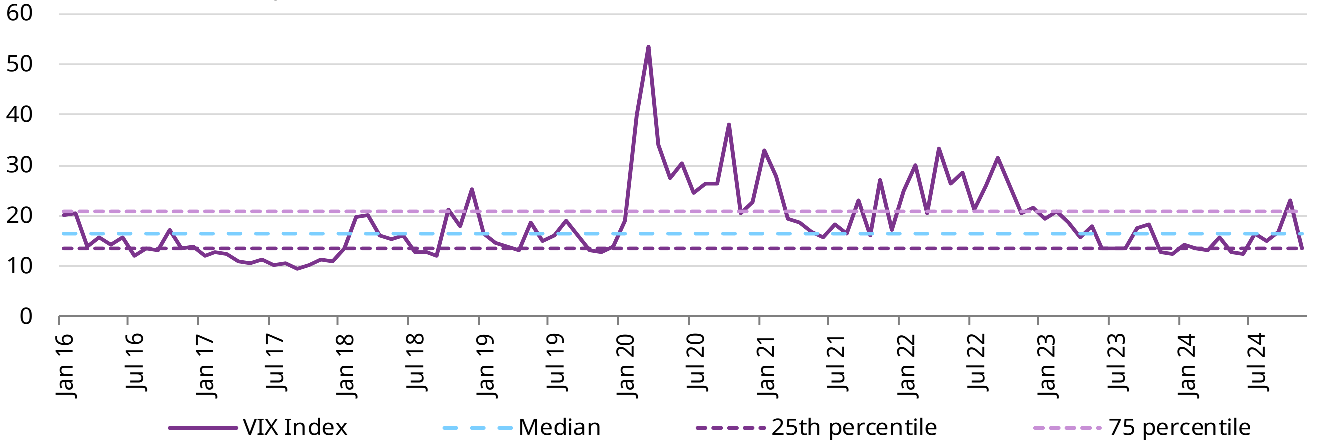
Market volatility

The VIX decreased throughout the month, reflecting lower volatility in financial markets, and finished the month near the 25th percentile.

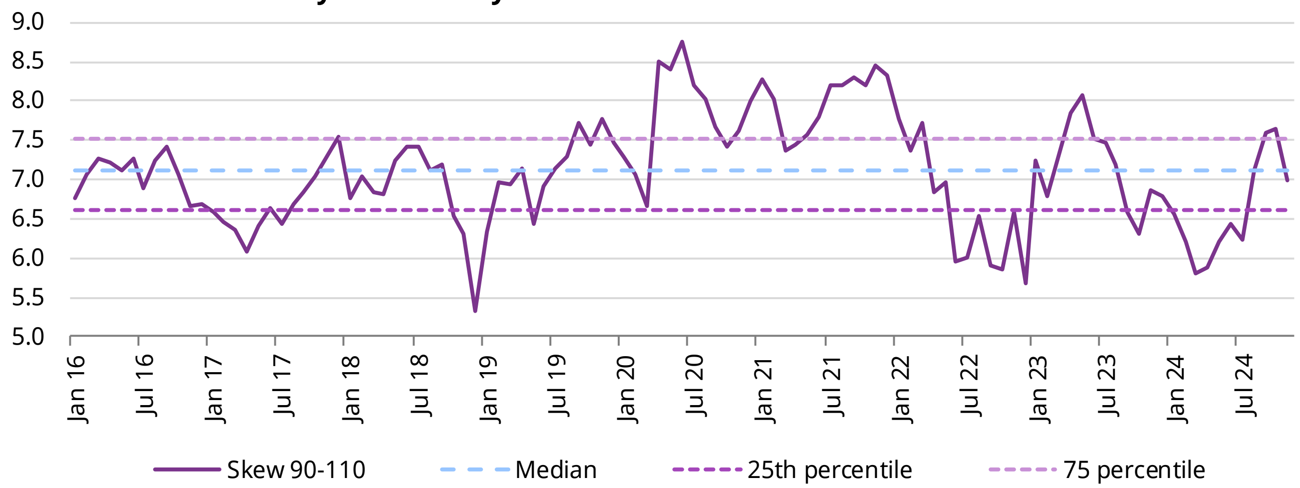
CBOE S&P Volatility Index ('VIX')



Source: Schroders, Bloomberg, 29 November 24. Using monthly data from 31 January 2016 to the date of this document.
For illustrative purposes only.

After spending the previous two months above its 75th percentile, the skew has now reverted to its median historical level. This means that the price differential between puts and calls is broadly in line with historical levels.

S&P 500 90% – 110% 1-year volatility skew



Source: Schroders, Bloomberg, 29 November 24. Using monthly data from 31 January 2016 to the date of this document.
For illustrative purposes only.

Access our equity derivative pricing tool here.

About our team

The Risk Managed Investments team (RMI) sits within the Schroders Solutions division. Since 1998, the RMI team has constantly innovated to offer a growing range of solutions, tailored to our clients' evolving needs. These include daily rolling of options, customised actively managed indices and enhanced volatility management techniques.

We design strategies to reduce the risk in our clients' portfolios. These are structured to capture upside returns whilst managing the uncertainty inherent in growth investing. Our solutions can be implemented across equity, credit, multi-asset or private markets and the underlying assets can be actively or passively managed by Schroders or a third-party manager.

Our clients value our solutions for reducing a wide range of risks and tailoring outcomes to their specific requirements. Our strategies provide efficient access to markets and Schroders active management skills. Through risk management we offer exposures that diversify portfolios vs. traditional asset classes. The team traded over £190bn notional of derivatives transactions in 2023.

Glossary of terms

Call Spread Collar: This strategy helps to manage the investment risk of an equity exposures by providing downside protection while limiting the upside potential to reduce the cost of the protection. The structure priced here sells a put option with 80% strike, buys a call option with 100% strike and solves for the strike of the upper call. The Sterling cash rate is used to fund the structure. The put option is geared so that the value of the structure is zero if the underlying index falls to zero.

Risk Reversal: This strategy aims to protect against moderate falls in the markets, while providing upside exposure if markets rally. It is effective for adding equity growth potential to portfolios when investors are cautious about having a direct equity exposure. The structure priced here sells a put option with 90% strike and uses the proceeds generated (along with the Sterling cash rate) to purchase a call option.

Condor: This strategy aims to profit when the investor anticipates minor stock price movements within a specific narrow range, allowing them to benefit from reduced market volatility. It is a non-directional options strategy that limits both gains and losses. An investor would usually purchase a condor when they expect realised volatility to be low but implied volatility to be high and returns to remain range bound. The structure priced here buys calls with 85% and 115% strikes and sells call with 90% and 110% strikes.

Skew: Volatility skew is a term in options trading that reflects the differing implied volatilities for options on the same underlying asset but with different strike prices. With higher skew, out-of-the-money puts and in-the-money calls can be more expensive due to increased demand while out-of-the-money calls and in-the-money puts can be less expensive due to decreased demand.