The Money Manager

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(VW508/02e) ETHAN S. ETZIONI is a Senior Vice President and Portfolio Manager of Oppenheimer Capital. He has been with the firm since June, 1981 and is responsible for the management of $3 billion in various derivatives programs. Particularly, he has made important contributions in the refinement and improvement of the Oppenheimer option pricing model, development of new products and programming of the necessary software. Mr. Etzioni received his Bachelor of Arts degree in economics from Tel Aviv University and earned his Master of Business Administration in finance from the Wharton School where he was elected to the Beta Gamma Sigma honor society. Mr. Etzioni has presented work on the topics of option valuation and risk control at the Amex Option Colloquium V, VI, VII, the New York Stock Exchange Cash Settled Index Option and Futures Conference, the National Option Society and the Pension Sentinel Group. His publications include: "Rebalance Disciplines for Portfolio Insurance", Journal of Portfolio Management, fall, 1986; "Portfolio Protection for Fixed Income Portfolios, Balanced Portfolios, Surplus Protection", Frank Fabozzi; Fixed Income Portfolio Strategies, September, 1989; "Buy Calls/Buy Bills", Investing, Summer 1989; "Indexing Can Be Beat", The Journal of Portfolio Management, Fall 1992; "Exposure Determines Proper Currency Hedge". Pensions & Investments, October 12, 1992. He is married, has one child, and his interests include basketball, tennis, squash, scuba diving and chess.

(VW508/01)(4744) **TWST: Mr. Etzioni, please begin by giving us a description of your role as portfolio manager at Oppenheimer Capital.**

Mr. Etzioni: Oppenheimer Capital's derivatives group has about $3 billion under management for about 15-20 clients. Most of what we do is return enhancement, where we write overvalued index options against our clients' equity portfolios with the idea of adding to their return. We've been doing that for 17 years and we've averaged 100-200 basis points of incremental returns over that time period. In addition, we use futures and options in various ways to assist the equity portfolio managers in managing their portfolios. For example, when a manager gets a new client, we buy futures so that they immediately gain full exposure to the market and as the manager buys their stocks, we sell off the futures. That way we maintain the right exposure. Or conversely, if they want to take a defensive posture and raise some cash, instead of selling off the stocks that they accumulated at great effort, we sell futures against their portfolio, then buy them back later when they feel that the protection is no longer needed.

We also have a 90-10 program where we buy Treasury bills and use the interest to buy undervalued index call options. This program is a low risk equity alternative that has captured 80 percent of the equity total returns without risking principal at all. This program, which we call PACE, has a live track record of 12 years. Or you can look at it as a premium cash management tool. Also we have a currency program that's based on identifying long-term trends in the currency markets and either investing money in that (as a separate asset class) or using that model to hedge pension fund overseas currency exposure. That's kind of a flavor of what we do here.

TWST: So you're not involved so much in the underlying equities but in the different hedge and appreciation strategies you've outlined?

Mr. Etzioni: That's true. We use derivatives in various ways to help our clients and to help the Oppenheimer Capital equity portfolio managers. As far as things that we do on individual stocks, let's say a portfolio manager wants to sell a particular stock above the market, we'll write a call against that and then he can let the stock get called away or, let's say, it's in a taxable account, he doesn't want to realize the gain now, he can write a call against the stock, take out some of the risk and postpone the realization of the gain until next year. That's the extent probably that we get involved in individual names. Our group does no fundamental research on any individual stock names. Oppenheimer Capital of course has a lot of very good research analysts that do that.

TWST: Are your clients institutions?

Mr. Etzioni: Yes, our clients are pension funds, whether corporate pension funds or public pension funds – mostly very large ones.

TWST: To what extent would a typical portfolio be invested in derivatives such as you outline?

Mr. Etzioni: A typical client might allocate as much as 30-40 percent of their equity assets to an option overwriting return enhancement program and if they are a large client, they might have several option managers. If they're a small client they probably have just one option manager.

TWST: Mr. Etzioni, what's your overall investment philosophy?

TWST: Mr. Etzioni, what's your overall investment philosophy?

Mr. Etzioni: It varies from program to program. As you can see, we have different programs but I guess the main thrust of most our programs is that we are very strong in valuing options in a statistical sense. We have our own proprietary option valuation model that we've developed over the years and that works on a real time basis. It's a substantial improvement beyond the original Black-Scholes model which is considered the base option model and we get a very accurate handle on the average liability on options. When we sell options, we collect premiums that are substantially above the average liability. So philosophically speaking we look at our call writing program like an insurance company looks as issuing many policies where we, like they, collect premiums that are substantially above the average liability. Then once in a while there are claims which we pay which is analogous to the calls that are in the money from time to time. Historically there's a remaining cash pool that grows and accumulates over the years. That's the added return that we provide to our clients.

TWST: Will you give us a brief outline of your method of valuing options?

Mr. Etzioni: Conceptually the way any option pricing model works is that you calculate the average liability on the option, given different market levels, and these different market levels are weighted by their corresponding probability based on the market's return dispersion. I'll use an example. Let's say the S&P 500 is now at 450 and we're looking to value a 460 call. Our computer model might tell us that there is a 5 percent probability of the market going to 480 and a 10 percent chance of the market going to 470. If it goes to 480 the call's worth $20, the difference between 480 and 460 so the computer does 5 percent times $20 plus 10 percent times $10 the difference between 470 and 460 and each one of those is a dollar so let's say in that case the average value of that call would be $2. And if that call sells for $3 or $4 in the marketplace, that's a good call for us to write.

TWST: What would the down side be of a strategy like this?

Mr. Etzioni: The risk is that in a market that continues to rise, as has been the case lately, call writing detracts from total returns. The fund still does very well in its underlying assets, however not as well as it would do in the absence of a call writing program. That's the down side. Let me also add that we only use index options in this program as opposed to options on individual stocks.

TWST: Do you invest in options on individual stocks at all?

Mr. Etzioni: Not for the purpose of the return enhancement overwriting program. We use them in the context of assisting equity portfolio managers to unwind positions but not in this context.

TWST: How does the currency program you mentioned take advantage of long-term trends in currency markets?

Mr. Etzioni: We've studied the currency markets carefully and the data shows very clearly that there are sustainable trends or at least there have been for over the past 20 years or so. To give you the order of magnitude, on average looking at the pound, the deutsche mark, the yen and the Swiss franc, the serial correlation of weekly currency changes, (serial correlation meaning the likelihood of one week's change being in the same direction as the other week's change beyond random, the average correlation comes out to 9 percent, which is fairly high given the large sample size. The trends in currencies have been well documented in the academic literature in many different articles. The reason we believe these trends exist is that demand for and supply of currency tends to be inelastic in the short to intermediate term. For example, we talked to a British manufacturer of construction equipment who markets scaffolding in the U.S. and we asked him (this was when the dollar was very weak relative to the pound) what do you do about the weak dollar? And he basically said that we absorb the currency fluctuations because we have salesmen out in the field making bids and we don't want to change our bid every Tuesday and Thursday so we absorb the currency fluctuations, maybe adjust our prices every year or two. What that means is that a weak dollar and a strong pound don't immediately reduce demand for pounds, in contrast to what we learned in Economics 101. In reality the lower demand only happens after a very long time. Therefore, an imbalance in the currency markets tends to persist for a while and that's why you have these trends. Also central bank intervention usually retards the adjustment of the currency to its equilibrium level, which also in a way helps create trends.

TWST: In addition to looking back on your trends of the past 20 years, do you also look ahead and try to anticipate currency moves?

Mr. Etzioni: We have determined that trends do tend to persist and we try to identify trends and ride them out and capture them. It doesn't mean that a trend can't change at any given point in time but the likelihood is that once a trend is in place, it's more likely to continue than to reverse. Ultimately it will reverse but that will only be once; it will continue for a while. For example, at the moment we're seeing a trend of the dollar weakening to a certain extent relative to the four currencies that we follow.

TWST: What about your program of undervalued call options purchased with the interest on Treasury bills?

Mr. Etzioni: The combination of purchasing undervalued index call options with the interest on a one-year Treasury bill is a program that makes a lot of intuitive sense because it gives an investor a way to participate in the equity market; it benefits from the fact that from time to time index call premiums do get very inexpensive and they can be in the equity market without risking their principal. Especially with the market as high as it is, people have fears about being in the equity market and here they can do that in a very low risk way. Again you can look at it as a cash management tool that enables you to earn premium returns over and above what short-term rates are, by the fact that you're capturing some of the equity risk premium. We buy a one-year bill at a discount so we know exactly how much interest we're going to earn throughout the year and we use that to buy calls. We are never going to invest more than the interest available in calls so no matter how poorly the market does, the client's going to get their principal back at the end of the year. And if the market does well, the calls may multiply several times in value as they have in the past and that will provide the client with a nice equity-like return.

TWS: What if the current trend in interest rates all of a sudden reversed itself? Would this mean problems for your strategy?

Mr. Etzioni: Actually the low rates are in themselves somewhat of a problem for the strategy because it means that we have less dollars with which to buy calls. Higher interest rates would probably mean that the market would go down short term, so we probably wouldn't do too well on the calls that we had outstanding at that time. However, relative to stocks and bonds, we'll do extremely well. Going forward we will have more interest to invest in calls so from that point on also we'll do well.

TWST: Sounds like a win/win strategy?

Mr. Etzioni: Nothing wins all the time. Going back to your earlier question about whether we use all these different programs for a client, a client hires us for a specific program. A client may hire us for return enhancement or for currency or for the buy calls, buy bills, so we just use whatever program we're hired for or, for the equity portfolio managers, we provide them these services separately.

TWST: What do you see the markets doing for the remainder of 1993?

Mr. Etzioni: We focus on valuing options relative to where the market is as opposed to trying to come up with a market opinion so we're really not in a good position to make that kind of call. I can say from what we're seeing, obviously everybody knows that the valuations are high and the market's up a lot and the returns of the past decade can't reasonably continue into the future decade and we're seeing that the demand for calls is pretty strong which is usually a contrarian indicator. So perhaps the market is due for a correction.

TWST: Don't they say that's like the tail wagging the dog referring to the options market effect on the equity market?

Mr. Etzioni: I don't think so. The impact that derivatives have on the markets, in general, as far as direction, is pretty short-lived. I don't think that derivatives have a lasting impact.

Perhaps in the crash they might have exacerbated it, but in general, I don't think the derivatives make the market be someplace it doesn't want to be. I think derivatives are helpful in the sense that they facilitate capital because risks can be spread out among several investors at very low cost and each investor can choose that portion of the return distribution that they're most comfortable owning. By spreading those risks out, you add liquidity to equities, increase the demand for equities overall and, as a result of that, facilitate capital formation.

One of the new things that we're offering clients is what we call a Diversification Overlay, where a client can swap equity returns. Let's say a client has only domestic large cap stocks. We can basically swap the client, take away let's say maybe 30 percent, 40 percent of their S&P exposure and give them exposure to international or small cap or emerging markets or even real estate. Basically all through a swap without the client having to liquidate their stocks and fire their managers. We can do all that through one derivative transaction. I think this ability to participate in many different markets at very low cost is an important advantage that derivatives offer.

TWST: The more you spread out your risk in this way are you also reducing your possible up side return?

Mr. Etzioni: No, not really. To the contrary, the best thing an investor can do is to diversify to the maximum extent possible which will reduce his risk, and then he can allocate a larger portion of his assets to aggressive asset classes. So whenever you reduce your risk, you can trade that off for additional return by putting more money in equities, more money in international equities, more money in all those asset classes that tend to provide higher returns over time. You're right in saying that you give up a return if you go from equities to Treasury bills; you're likely to give up return over time. But if, instead of owning only domestic large cap stocks, you own some mid-cap and small cap and international and emerging markets and real estate, etc., you're reducing risk without giving up expected return. Then you can trade off that reduced risk for more return by allocating more assets to those classes.

TWST: Getting back to what we were talking about a minute ago, about the impact of derivatives and similar instruments on the market, do you think that this impact will increase as trading mechanisms get more sophisticated?

Mr. Etzioni: One of the things we've been concerned about over the years is the impact of the expiration of index options and index futures on the double witching and the triple witching days. We've started to utilize the new flex product offered by the Chicago Board of Options Exchange. That basically is a system that enables the client to customize the expiration date; they can customize a lot of different variables but what appeals to us is the customization of the expiration date because that enables us to avoid the double witching and triple witching and therefore we'll get better settlements on these contracts for our clients.

TWST: Do you see expiration date customization taking hold so that eventually we won't have double and triple witching?

Mr. Etzioni: We're definitely seeing a growth of over- the-counter derivatives and the flex product has been developed because the exchanges want to cut into the market share of the over-the-counter dealers. And the more of those you have, the less concentration you have on the double and triple witching. I think also to a certain extent the market learns to anticipate these expirations and absorb the flow more easily. For example, today the morning expiration (the expiration is the third Friday of the month, which happens to be today -- April 16, 1993) was a non-event. It didn't have any significant impact on the market.

TWST: If we tacked one of your derivative strategies onto a portfolio, what would the impact be on the overall return?

Mr. Etzioni: If a client gave us $100 million to overlay with index options and we use the full authority for call writing and half the authority for put writing, it's reasonable to expect that we'll add 100-200 basis points per year over a market cycle. That means an additional $1 million or $2 million per year. That's been our long-term average. In the recent past we've done less well because the markets have been going up so much.

TWST: How much of a difference would that make?

Mr. Etzioni: Over the last couple of years we've actually detracted from returns in our call writing program.

TWST: But in a down market, would this protect the portfolio?

Mr. Etzioni: Right. In a down market this would protect the portfolio and add more dollars over time. That has been our long-term record.

TWST: Do you set yourself certain performance benchmarks?

Mr. Etzioni: Our benchmark is to add 100 basis points per year on average over a market cycle.

TWST: Mr. Etzioni, is there anything else about derivatives you'd care to discuss at this time?

Mr. Etzioni: There's always resistance to derivatives, just as there is to anything new, but I think slowly institutional investors, particularly pension funds, which is our target market, are starting to view them as useful tools. They're not as afraid of them as they used to be in the past. They're seeing that there is some value to be gained and also our own equity portfolio managers are becoming more comfortable in using them. So I'm pleased to see that their use is spreading, gaining, and I see that as a positive.

TWST: How widespread is the use of derivatives among pension funds?

Mr. Etzioni: I would have to guess that among the large pension funds over half are using future or options in one way or another, whether it's for return enhancement or to control asset allocation or to control currency exposure or any of the other strategies I mentioned, like to get an account invested quickly or to diversify. So I would say that most large pension funds are using derivatives in one way or another.

TWST: Is that quite a change from several years ago?

Mr. Etzioni: Definitely. As far as what the exact numbers are, I don't have the statistics.

TWST: Thank you.

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