Do Knock-Out Options Need to Be Knocked Out?

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In financial markets' version of man-bites-dog, the man who snatched $1 billion off the Bank of England and slings billions around the globe with a single phone call is asking regulators for protection from derivatives.

At a news conference last week in Vienna, George Soros contended that so-

By Wall Street Journal reporters Michael R. Sesit in London and Laura Jereski in New York.

called knock-out options destabilize world currency markets and were largely responsible for the dollar's steep fall against the yen and mark this year. In earlier remarks, he likened these instruments to crack cocaine, and urged that they be curbed and registered with bank regulators.

Many traders and analysts think the Hungarian-born financial guru's accusations are far wide of the mark. But they do concede that knock-out options – also known as "barrier" options—can roil even the mammoth foreign-exchange market for brief periods.

Knock-out options, like regular options, give the holder a right to trade an amount of currency at a set price for a specified time. But they're rendered worthless, or "knocked out," if the market hits an agreed-upon price barrier. Such options are cheaper than conventional ones, due to the risk of being knocked out before their time.

These and other exotic barrier options are gaining favor, particularly in currency markets, where volatility makes them especially cheap relative to standard options. "This has been a [progressive] trend in the derivatives market over the last five years or so," says Richard Kleinberg, head of derivatives at D.E. Shaw & Co. in New York.

By now, most players and regulators have come to accept such options as a regular part of the currency game. Central bankers have examined the effect of options on markets numerous times in the past decade, and lately some of them have been giving special attention to controversial knock-outs. But so far they aren't nearly as perturbed as Mr. Soros.

While sometimes the effect of options "is large enough to be a contributor to a major move, it tends to be short-lasting," says a former senior central banker. "Most foreign-exchange traders now take it for granted that every once in while you will get a little extra kick in the price movement from a large number of options

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Knock-Out Options Are Popular With Foreign-Exchange Traders

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in the market."

What causes that extra kick? That gets complicated. Partly it results from the hedging activities of dealers who sell knock-outs. Dealers' knock-out hedges typically involve staggered purchases and sales of normal options. And those transactions, in turn, may set off intense trading at other dealers to execute a hedging strategy known as "delta-hedging." This strategy requires the hedger to keep selling into the market as it falls, and to continually buy when the market rallies. By piling on the prevailing price trend, delta-hedging can exaggerate market moves.

What's more, customers who buy knock-out options to hedge currency risk may exaggerate the kick. That's because if prices move far enough to knock out their hedges, they often rush to protect themselves by dumping the vulnerable currency.

For example, David D. Hale, chief economist at Kemper Financial Cos. in Chicago, notes that in the past year, many Japanese exporters moved to hedge against a falling dollar with currency options. Confident at the time that the dollar would fall no further than 95 yen, the exporters chose options that would knock out at that level.

Once the dollar plunged through 95 yen early last month, "they lost everything," he says. The dollar then tumbled as the Japanese companies, "which had lost their hedges, scrambled to cover" their large exposures by dumping dollars.

"The Japanese companies never thought the yen would get this strong," says Mr. Hale. "It's ironic. They are now creating the crisis they didn't want to happen."

'Sucked Into the Vortex'

Making matters more volatile, dealers say that pitched battles often erupt around knock-out barriers, with traders hollering across the trading floor of looming billion-dollar transactions. "People hear the volume in the market through the brokers, so the movement can be extra rapid," says a managing director in one large bank. Often, he says, others will pile in to ride the fast-moving wave. In three or four minutes, it's all over. "But in that time every trade gets sucked into the vortex," he says.

Just how disruptive these episodes are remains a matter of some debate. "They cause price movements to dramatically overshoot where they would naturally be," says Raymond Dalio, president of Bridgewater Associates, which manages $3.5 billion in currency exposures.

Traders counter that knock-out options only add vim to the trend-following that animates the currency markets. "The impact of a knock-out option on the spot market is exactly the same as a stop-loss order, which we've lived with for dozens of years," says Klaus Said, head of global foreign exchange for J.P. Morgan & Co. Stop-loss orders are instructions that money managers, corporations and buy or sell a currency if it rises above — or falls below — a predetermined level. In rapidly moving markets, it gets difficult to execute those trades precisely.

Traders contend that Mr. Soros's moaning and groaning could relate to reports that his firm recently got blindsided by sudden swings in the dollar-yen exchange rate that some say were triggered by knock-out options. A spokesman for **Soros Fund Management** declined to comment.

Curiously, the more prices whipsaw, the more appealing knock-outs become, compared with normal options. In volatile times, normal options become more expensive, because big price swings raise the odds that these options will produce profits for their owners. By contrast, knock-outs get cheaper when markets become mercurial, because there's a greater chance the knock-out barrier will be hit, and the option will expire worthless.

Keeping Cost Low

"People don't want to pay the premium [to buy normal options], so banks and other dealers try to do things to make the cost as low as possible," says Les Halpin, managing director at Record Treasury Management Ltd. in Windsor, England.

According to Demetri Papacostas, head of currency option marketing at Chase Manhattan Bank, a six-month "call" to buy yen at 80 to the dollar costs about 3.34%, or $3.34 million for every $100 million bet or hedge. A call option that knocks out if the yen goes to 86 costs only 1.94% — about half the cost of the straight call. Six months ago, when markets were tamer, the straight call cost only 1.88% and the knock-out 1.49%.

While the jury is still out on knock-outs, central bankers so far pooh-pooh Mr. Soros's claims that these options are largely responsible for the dollar's 16% plunge against the yen and its 11.5% drop against the mark this year. They say much bigger factors were loss-cutting by dollar bulls, and increased selling by dollar bears who wanted to raise their bets.

In any case, "knock-out options won't change the sentiment or [long-term] trend of currency markets," says Jerry Del Missier, head of foreign-exchange derivatives at Bankers Trust Co. in London. The foreign-exchange market is too large and liquid for that.