

4. Readers intending to use index options to hedge against the market risk entailed in investing in individual securities should recognize the complexities of utilizing index options in this manner. Market risk is the risk that factors affecting the stock market as a whole may have a similar effect on the price of a particular equity security. Historically, some securities have tended to be highly sensitive to factors influencing the market generally; others less so. As a result, different securities may be viewed as involving different levels of market risk. In addition, a security's sensitivity to broad market influences may change over time, so that the same security may involve different levels of market risk at different times.

Investors using index options in this manner should also understand that they remain subject to company risk—that is, the risk that factors affecting a particular company, such as its market position or the quality of its management, may cause its securities to perform differently than the market as a whole.

In addition, readers intending to utilize index options to hedge a diversified securities portfolio against market risk should understand that unless the securities in the portfolio exactly mirror the securities in an underlying index, the portfolio and the index may respond differently to a given market influence. For this reason, the use of index options for hedging purposes involves special risks that are not present with "true" hedges—i.e., hedges composed of options on the specific securities in the hedged position. These risks are greatest when options on broad-based indexes are used to hedge a nondiversified securities position. Except where the composition of the position to be hedged is very similar to that of an underlying index, index options may best be understood as a means of reducing some but not all of the risks of a securities portfolio position.

Readers should also be aware that it may not be possible to purchase or liquidate a portfolio of securities at prices that exactly converge with the prices used in determining the exercise settlement values of some index options. For example, if the underlying index is comprised in whole or part of securities whose primary market is the NASDAQ stock market, an investor cannot be certain that he will be able to effect transactions in those securities at the opening or closing prices (as the case may be) used in determining the exercise settlement value.