Managing a Portfolio of Real Options

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Managing a Portfolio of Real Options[i]

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Firms have to consider growth and switching options in developing a portfolio of strategic options. While growth options relate to early commitment in growth opportunities, switching options give firms an essential form of flexibility to handle different sources of uncertainty. Too much commitment could create vulnerability; too little could hinder competitive advantages. Therefore, managers have to consider the sources of uncertainty to determine the adequate level of investment in switching and growth options, according to a study co-authored by a researcher at The Ohio State University.

Some sources of uncertainty generate growth opportunities while other sources might induce switching opportunities, according to the study "Managing a Portfolio of Real Options". For example, when market demand is the main source of uncertainty, growth opportunities may dominate the strategic decision. Ohio State researcher Jaideep Anand co-authored the study with researchers Raffaele Oriani in Italy and Roberto S. Vassolo in Argentina.

For managers, growth and switching options represent the trade-off between flexibility and commitment, the study says. Managers have to determine what is unique about their portfolios and how to incorporate that uniqueness when assessing portfolio value. They also have to understand how market and technological uncertainty can have different effects on the value of switching and growth options.

With market uncertainty, demand and inconsistencies of customers' needs for new products could affect market size and sales. In this case, growth options limit firms' losses to their initial investments. However, potential gains from future growth opportunities are unlimited.

With technological uncertainty, firms have to choose the "right" technology, which means investing in a portfolio of unrelated assets. This gives them switching options that allow them to hedge against the risk of being locked out of the market because they have not invested in the right technology.

However, the value of the switching option depends on the difference among the values of the assets that can be exchanged.

[i]Original article

http://www.books.mec.biz/downloads/Real_Options_Theory/NDc1MDk2NzA1

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