

DERIVATIVES

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COORDINATOR'S MESSAGE

By Ian Flack

Welcome to 2009, hopefully another profitable year for derivatives traders.

This bulletin has a focus on covered call options, a strategy used by many savvy traders in current market conditions. I know this strategy worked very well for many traders in 2008.

We start with Luke Gleeson's introduction to covered calls and their use in sideways markets.

First time contributor Daniel Goulding then provides a detailed explanation of writing covered call options. Daniel is a regular contributor to the "Grow Your Wealth" website which has lots of great reading.

For those wishing to further research the use of covered calls the ASX website has lots of information including a Covered Call Calculator

http://www.asx.com.au/resources/calculators/options/covered_call.htm and a 7 step guide at http://www.asx.com.au/products/options/how/7_steps_to_covered_call_writing.htm.

Vimal Mehta has provided an excellent summary of the recently released "Getting Started in Currency Trading". If you are interested in getting started in Forex, Vimal's summary is a great guide to the contents of this book by Michael Duane Archer.

Thanks to Luke, Daniel and Vimal for their contributions.

Ian Flack, Dip TA (ATAA) is an AIA member and private trader who has been trading primarily commodity, index and currency futures for 12 years. He can be contacted on ian@ranges.org.au.

INVESTING IN A SIDEWAYS MARKET

By Luke Gleeson

An appropriate investment strategy, through what was a tremendously strong four-year bull market from March 2003 to October 2007, was to simply buy and hold, especially for those investors approaching retirement.

At the 2007 AIA annual conference I addressed the merits of covered call writing as an appropriate investing strategy in a sideways market, both for individual investors and for the self-managed super fund investor, but only on the grounds that their investment strategy and risk profile permitted this approach. As the Australian market at that point had shown four solid years of 15%, or more, growth, it was important to encourage investors to be dynamic when investment markets finally turned, as they inevitably have. Hence I introduced the covered call strategy as a valid way to generate a level of outperformance for their portfolios. The strategy also offers the SMSF investor a way to increase the yield and income on their portfolio, providing they are willing to hold the underlying share and take on equity market risk in a sideways to falling market.

The covered call strategy involves selling a call option over the shares the investor already owns at a predetermined point in time, typically 30–60 days before the call option expires. As the underlying shares are already owned by the investor the strategy is known as a 'covered call' strategy.

Options have, over the years, attracted negative criticism when they have been used by investors who have attempted to pick the market using 'naked trading' strategies and have lost out in the process. However, the covered call strategy is 'covered' because the investor owns the underlying instrument, which limits the potential loss to the shares falling in value.

Investors who adopted the covered call strategy have generated good returns from their diligence and willingness to evolve with the markets. Throughout the past year I have been dividing portfolios into two categories. One category focuses on a concentrated group of defensive stocks, that have the underlying earnings streams to maintain their current dividends; and the other group of shares I am happy to hold through the economic cycle for the long term.

For the broader groups of shares, Macquarie research recommendations suggest that these companies may not grow their earnings in 2009, but will continue to pay a healthy fully franked dividend. For these stocks we would consider adopting the covered call strategy. During the past year this strategy has generated a significant amount of outperformance for investment portfolios.

With the current levels of volatility within the Australian market, it would be highly recommended for investors who are interested in this strategy for their current portfolio to seek the guidance of a professional investment adviser. Accredited derivatives advisers can provide advice to ensure the strategy fits their clients' individual financial circumstances and assist in the implementation as appropriate. This strategy may be suited to the dynamic investor who might be willing to change their strategy as the market changes.

As investment markets have shown investors during the past 13 months, no stock is a buy forever and no stock is a sell forever. One of the only constants in investment markets is change. I wish you all the best with your future investing.

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KEEPING ONE'S OPTIONS OPEN: COVERED CALL WRITING

By Daniel Goulding

This article is the first in a three-part series covering option strategies for the conservative investor. The intent of each article is not to educate, but rather inspire the reader into seeking further information on this beneficial, albeit complicated subject. As such, I will endeavour to proceed quickly without becoming entangled in the intricacies of the subject matter.

When the term *options* are mentioned, the general public tends to conjure images of brazen speculators wagering on the vagaries of the stock market. While options can be used for such a purpose, they originated as a tool for risk management.

A number of option strategies exist for the conservative investor whose aim is to mitigate the level of risk associated with their portfolio. The strategies typically employed include covered call writing, buying put options as an insurance policy, and the collar (commonly referred to as the protected covered write in Australia). In this article I introduce the reader to a strategy called covered call writing.

This strategy entails an investor writing (selling) call options against stock that they own. The objective is twofold: (i) to generate additional income to supplement dividend income; and (ii) to provide a modest amount of protection against downside risk with respect to the underlying shareholding.

A well-executed covered call strategy will result in an outcome in which the risk-return profile is skewed in the favour of the investor. ***In layman's terms, the covered call writer will enjoy a superior return, with less risk,*** compared to an investor who adheres to the buy-and-hold mantra with no recourse to this strategy. The potential for greater returns with less risk - is that not the goal of every conservative investor? While covered call writing is not the Holy Grail of investing, it nevertheless offers the conservative investor a powerful means of wealth creation with a modest degree of protection built in.

A call option is a contractual arrangement between two parties whereby the holder (the party who buys the call option) has the right to buy the underlying security (each option contract is usually equal to 1000 shares) at a specific price referred to as the exercise price, on or before a specific date referred to as the exercise date (some option contracts can only be exercised on the expiry date itself). In exchange for the potential obligation to deliver shares, the writer (the party who initially sells the call option) of the call option is paid a consideration in the form of a premium, the price paid for the option. The premium is determined by a number of factors; the amount by which the share price is above or below the exercise price, the time to expiry and the implied volatility of the stock are the dominant factors in pricing.

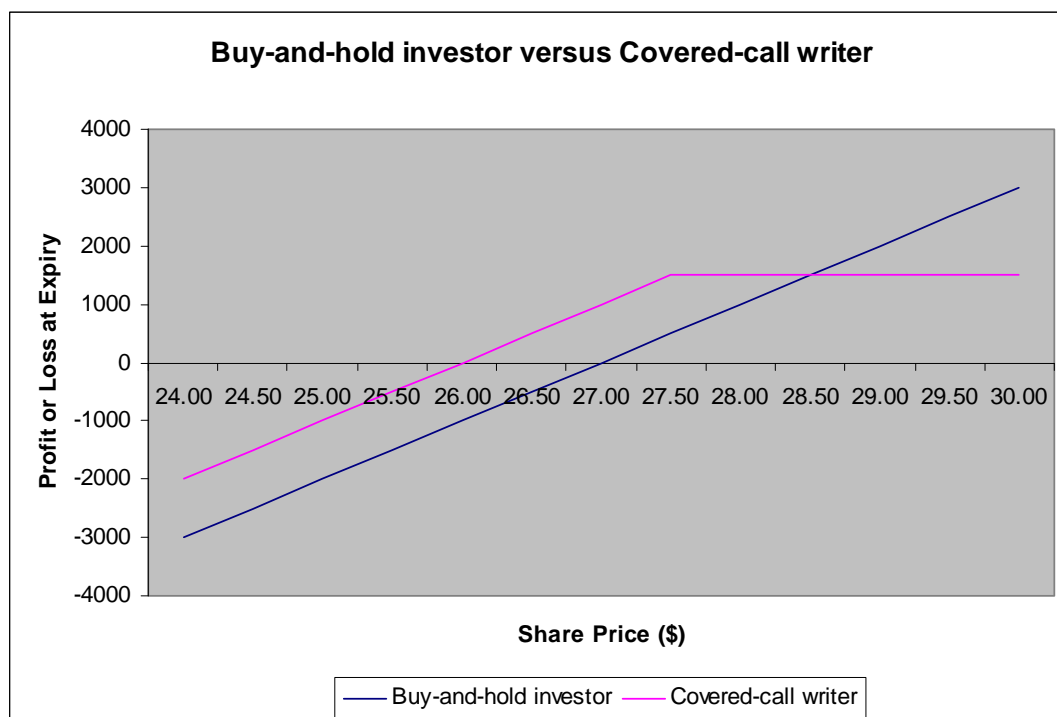
Leading up to expiry, one of a few events can occur.

If the underlying stock is trading at a level below the exercise price, the call option should expire worthless - why exercise the call option when one can purchase the stock on market for a lower price? In this instance, the writer retains their shareholding in addition to the premium they received for selling the call option.

If the underlying stock is trading above the exercise price, the call option runs the risk of being exercised by the holder. In this outcome, the writer must part with their stock as per the terms of the contract. The writer, however, retains the premium paid to them by the holder of the contract.

For example, an investor with 1000 shares in Woolworths (WOW) believes that the stock is fully valued at the current level of \$27.00 and that it is unlikely to move much higher over the next six weeks. Accordingly, the investor sells 1 WOW February 2009 \$27.50 call option (the exercise date and exercise price are decided by the writer who can select from a menu of choices) for a premium of \$1.00 per share or \$1000 in total. By selling this call option, the writer has agreed to forego upside above \$27.50 before expiry in late February in exchange for \$1000 in premium, paid

upfront. The premium can either be viewed in the context of additional income or as a moderate hedge against downside risk. The graph below depicts the possible outcomes at expiry.



Perusing the graph above, the covered-call writer enjoys a superior return with less risk than the buy-and-hold investor at any share price up to \$27.50 at expiry. Specifically, the covered call writer comes out ahead by the amount of the premium, in this instance, \$1000.

Between \$27.50 and \$28.50 at expiry, the covered call-writer continues to enjoy a superior return with less risk, though the exact amount depends upon the closing price of WOW.

The maximum profit that the covered-call writer can enjoy is \$1.50 per share (the exercise price of \$27.50 less the current price of \$27.00 plus the premium received of \$1.00) or \$1500 in total. This equates to a share price of \$28.50. At any point above \$28.50, the buy-and-hold investor enjoys a superior return, albeit with greater risk than the covered-call writer.

Two alternative outcomes not discussed here are where the covered-call writer chooses to cancel the existing contract or replace it with a new contract ahead of expiry. These scenarios are beyond the scope of this article.

In the case study above, the covered call writer had to err by more than 5% over six weeks before they come out behind their counterpart. How often does a large industrial blue chip stock move by a significant degree in a short period of time? Fortunately, the probability is not that great, otherwise I would be out of a job!

A well executed conservative covered call writing program can earn up to 20 per cent in premium per annum in the current market climate (the more aggressive the writer is, the higher the potential return). And that does not take into account any dividends and franking credits you may receive through the year. In this context, you may never look at your portfolio again in the same light. Rather than chasing capital growth, you may simply look at your portfolio as a vehicle for generating a significant income stream, with potential capital gains a bonus.

While a covered call strategy can reap immense rewards for the investor over the long-term, the market can be most uncooperative in the short-term. Selling call options, in many instances, will preclude you from participating in upside on the back of takeovers and significant profit upgrades – in such instances, potential exercise will be most unwelcome. One must remember however that

writing covered calls, like investing, is a long-term strategy. Only when the market has gone through a complete cycle will the advantages of covered call writing be evident.

Before trading options, it is imperative that you have an excellent comprehension of the subject matter. It is not an easy subject, but then again, nothing worth doing is ever easy. I recommend seeking the counsel of an experienced advisor, if only, in the early stages of your options career. While the running costs may be higher than a do-it-yourself campaign, the advice provided could prove priceless.

Daniel J. Goulding is a Senior Client Advisor and Head of Derivatives with ABN AMRO Morgans in Townsville. He is the author of a weekly commentary on the market, the Sextant Report, which can be found via the Townsville branch website, www.growyourwealth.com.au.

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GETTING STARTED IN CURRENCY TRADING BOOK REVIEW

Reviewed by Vimal Mehta

Title: **Getting Started in Currency Trading**
Author: Michael Duane Archer
Publisher: John Wiley & Sons, Canada, 2008
ISBN: 9780 4702 67776
RRP: \$27.95

When it comes to trading, most retail traders focus on ASX-listed shares. However, currencies are by far the largest asset class, with an average of AUD\$5 trillion traded globally each day, including around AUD\$100 billion of spot foreign exchange in Australia.

With such a large market, Michael Duane Archer has written his book "Getting Started in Currency Trading" to "introduce the novice investor to the exciting, complex and sometimes profitable realm of trading world currencies on the foreign exchange markets (FOREX)." Additionally, Archer hopes his book will "serve as a reference guide for stock and futures traders who wish to explore new trading opportunities."

Archer's book begins with a brief overview of the FOREX market, an historical overview of currency trading, and the two primary methods for participating in the FOREX market as a retail trader. Some of this introductory section is written in a question-and-answer style and by the end of it he hopes to dispel any myths the reader may have about FOREX.

"Getting started" is part two of Archer's book and here he discusses the regulatory environment, the jargon used in the FOREX market and how to perform some basic calculations relevant to currency trading. Also included is a comprehensive section on selecting a FOREX broker, opening an account and the different types of orders that may be placed.

Continuing on from the basics covered in part two, "The tools of the trade" are covered in detail in part three. Here, Archer discusses the two major schools of thought – fundamental analysis and technical analysis; covering the advantages and disadvantages of each as well as offering ideas to

the reader on how to select trading tools from these different approaches to assemble a basic personal trading system. Finally, this part finishes with a preview of the various FOREX products and services available from third-party sources to assist with sorting through the vast array of information available to the budding currency trader.

While parts two and three cover a lot of theory – the reader has almost finished reading two-thirds of the whole book by the end of part three – I found the content easy to read as well as being comprehensive and interesting. Archer uses a lot of diagrams, graphs and calculations throughout the text, as well as providing “Tips”, “Rules” and “Do’s and Don’ts”. Additionally, he provides websites to direct the reader where to conduct his or her further research into the particular topic being discussed. End-of-chapter summaries highlighting the most important points are also provided.

Despite spending so much time discussing theory and analysis up to this point, several times during parts two and three, Archer points out to the reader that “your analysis of the market is only one component of your trading system” and that “most traders who fail (and most traders do fail) tend to spend all of their energies on developing a trading system at the expense of money management and trading psychology.” So it is in part 4, “The Complete FOREX Trader” that Archer discusses money management and trading psychology, as well as various FOREX tactics and strategies, how and when to regroup when things don’t go as planned and how to keep good records for tax purposes and trading performance reviews.

Finally, in part five Archer discusses options and exotics and their use in advanced strategies such as rollovers, hedging and arbitrage. Archer points out that while this section is optional for novices, all traders should at least be aware of ongoing market research and the advanced FOREX techniques available. Following the final section are the appendices, a list of resources (periodicals, books and websites) and a comprehensive glossary of terms.

At the beginning of the book, it states that “the author’s attempt has been to make *Getting Started in Currency Trading* an all-in-one introduction as well as a handy computer-side reference guide”. I feel that Archer has done an excellent job at this. Despite the book being aimed at the American reader, Australian readers will also gain a lot out of his book, but will have to conduct their own research to determine whether the FOREX markets and trading have a place in their portfolio.

MICHAEL DUANE ARCHER has been an active commodity futures and Forex trader for over thirty years. He has worked in various advisory capacities, notably as a commodity trading advisor and a SEC-registered investment advisor. Archer operates www.fxpraxis.com and is a professional Forex money manager.

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