

DERIVATIVES

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COORDINATOR'S MESSAGE

By Ian Flack

Welcome to the April Derivatives Bulletin.

Daniel Goulding's part 2 of his 3 part "Keeping one's options open": gives an excellent introduction to using put options as an insurance policy against movement in the price of shares in your portfolio.

Andrew Baxter's "Stock repair strategy" is a timely contribution for those who are still holding shares that have lost value and believe they now have some upside movement on the horizon. Andrew's strategy uses options to profit from this situation.

I will certainly be printing off a copy of Daren Markisic's guide to the "Cause and Effect" of US Fed Data and US Business Activity Financial Data announcements. Daren takes the mystery out of much of this information. It is a must for those of us that watch the financial media often confused about much of the fundamental jargon that many technical analysts don't understand.

Once again *Good Trading*.

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.flack@melbournefc.com.au.

KEEPING ONE'S OPTIONS OPEN: PUT OPTIONS AS AN INSURANCE POLICY

By Daniel Goulding

This article is the second 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* is mentioned in a financial context, 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 the strategy of buying put options as an insurance policy.

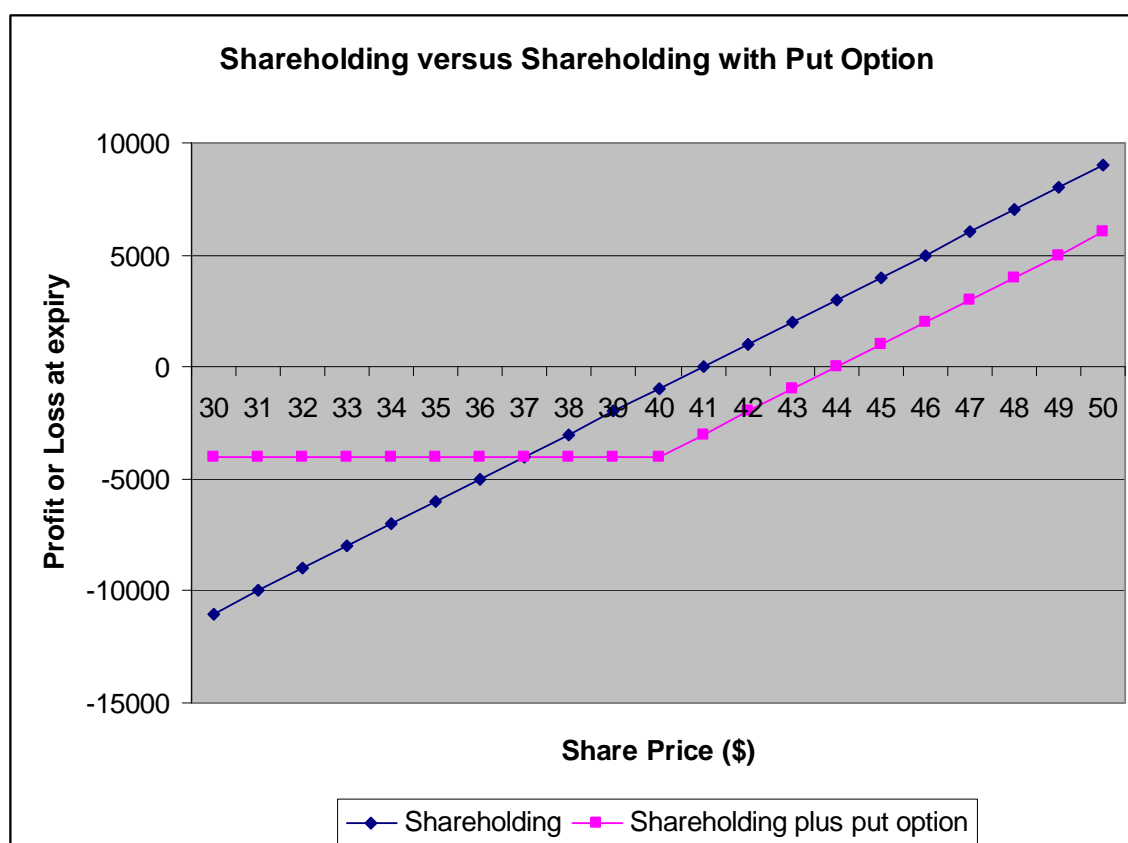
This strategy entails an investor buying put options over stock they own. The objective is to obtain protection against downside risk with respect to the underlying shareholding.

A put option is a contractual arrangement between two parties whereby the holder (the party who buys the put option) has the right to sell 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 this benefit, the holder must pay a consideration in the form of a premium. The premium is determined by a number of factors; the amount by which the share price is above or below the exercise price and the time to expiry are the dominant factors in pricing.

A put option is akin to an insurance policy. By paying a premium, the holder obtains protection against any loss beyond the exercise price of the option. The difference between the current share price and the exercise price of the put option is analogous to the excess. The higher the excess, the lower the premium and vice versa. Each option contract has an expiry date, at which point the insurance policy lapses. If the investor wishes to maintain protection, they must renew their insurance policy by buying a new put option.

For example, an investor with 1000 shares in Woodside Petroleum (WPL) believes that the stock, currently trading at \$41.00, is vulnerable to a moderate decline in the short-term. Given that they remain bullish about the company's long-term prospects, the investor is reluctant to exit the stock given transactional costs or other considerations such as the possibility of being incorrect or being hit with a large capital gains tax bill. Accordingly, the investor buys 1 WPL June 2009 40.00 put option @ \$3.00 or \$3000 in total. No matter how far WPL falls before expiry in June, the investor can sleep easy at night in the knowledge they have an insurance policy in place protecting against losses below \$40.00 on or before June 25 (the relevant expiry date). The graph below depicts the possible outcomes at expiry.

Perusing the graph below, the maximum loss faced by the investor who purchases the put option for protection is \$4000 (the cost of the put option plus the difference between the current share price and exercise price of the option) no matter how steep any potential decline in the share price. The buy-and-hold investor, on the other hand, is fully exposed to any material decline.



Obviously protection comes at a cost however. At any price above \$40.00 the buy-and-hold investor receives a superior return than the investor who purchases the put option, in this instance \$3000 (the cost of purchasing the put option). While the prospect of a lower may deter some investors from this strategy, we should remember that most, if not all, insurance policies are purchased with the hope they will never be called upon. And it is no different for investing. The put option limits downside risk while still offering the investor full exposure to potential upside in the share price, albeit less the cost of the put option. In stark contrast, the investor who has no recourse to options is faced with a tough decision: either sell the shares and miss out on any potential upside in the share price or hold onto their shares with the possibility they may experience a significant decline.

Buying a put option as an insurance policy is a conservative option strategy that should be contemplated by most investors, subject to their own investment nuances. In the third and final article in this series, I reveal how the investor can obtain free insurance, called a collar, through combination of the first two strategies covered in this series.

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. This report was prepared by Daniel Goulding through independent research facilities and contains an independent view to ABN AMRO Morgans Limited. It is not intended for use by any third party, without the approval of Daniel Goulding. While this report is based on information from sources which are considered reliable, its accuracy and completeness cannot be guaranteed. Any opinions expressed reflect my judgment at this date and are subject to change. ABN AMRO Morgans Limited, its directors and employees do not accept any liability for the results of any actions taken or not taken on the basis of information in this report, or for any negligent misstatements, errors or omissions. This report is made without consideration of any specific client's investment objectives, financial situation or needs. It is recommended that any persons who wish to act upon this report consult with their investment advisor before doing so. This report does not constitute an offer, or invitation to purchase, any securities and should not be relied upon in connection with any contract or commitment whatsoever.

STOCK REPAIR STRATEGY

By Andrew Baxter

Given the large fall in the market over the past 12 months, many investors have bought shares at higher prices than currently being traded on the market. Now is an opportune time to be looking at how to recover some losses on portfolios with a stock repair strategy. The strategy is designed to recover losses with a modest rise in share prices. While it is difficult to forecast future prices, the recent rally seems to be longer lasting this time.

For example, if you bought shares of BHP and it has dropped significantly (10% for example) since you bought it, you could use the Stock Repair Strategy to recover that 10% loss as long as the BHP rises about 5%. How this is achieved is buying call options on BHP and then selling twice the amount purchased to fund the strategy.

The Stock repair strategy has many benefits to the Investor. The main advantage is that it is a no cost or low cost strategy. Let's work an example to show exactly how the stock repair strategy works:

Stock Repair Strategy Example: BHP Ltd

Let's assume you bought 1000 shares of BHP shares at \$34 and it fell 10% to \$30.60, losing \$3400 in total value.

You wish to quickly recover that lost 10% using the Stock Repair Strategy.

You buy to 1 contract (representing 1000 shares) of BHP with a \$32 strike call options valued at \$1.00.

You then sell 2 contracts (representing 1000 shares) of BHP with a \$34 strike call options which are valued at \$0.50

The cost of the trade is: $(\$0.50 \times 2000) - (\$1.00 \times 1000) = \$0$ (Ignore brokerage fees for now)

There is no margin to pay for this trade as you already have 1000 BHP and these would be lodged as collateral. The strategy obviously works the best when the price of BHP rises to higher than \$34.00 at expiry as you get exercised for the 2 sold call options.

Stock Repair Strategy Example If Stock Exercised

Assuming BHP rises to greater than \$34 at expiry date and you are exercised

Total Profits = sale of 2000 BHP at \$34.00 minus purchase of 1000 BHP at \$34.00 and 1000 BHP at \$32.00

= \$2000 profit

Investor has exited BHP with a profit of \$2000 using options.

Of course BHP may not increase above \$35.00 at expiry but the strategy still allows the Investor to profit as long as BHP is higher than \$32.00. The strategy allows the Investor to break even if BHP is at \$33.00 as shown below.

Stock Repair Strategy Example Breakeven Calculation

BHP rises to \$33.00:

The 1 bought call with a \$32.00 strike would be worth \$1.00 while the sold \$34.00 call options would now be worth nothing. The existing shares have a value of \$33,000.00

Breakeven:

BHP shares now \$33,000 = a loss of \$1000.00 in value

Bought BHP \$32.00 Call option now worth \$1.00 = \$1000.00 profit

Sold \$34.00 Call options expire worthless = \$0.00

Overall Investor has reduced the cost of BHP shares to \$33,000 which is breakeven.

The Stock Repair Strategy allows the Investor to at least recover paper losses for no increased cost (excluding brokerage). The shares don't have to rise to the original purchase price for the Investor to at least breakeven. The strategy shown above only required BHP to rise by 7% before the Investor had a breakeven position, even though the stock had originally fallen 10%.

There are a number of benefits for Investors who use this strategy to actively manage their portfolios. The main advantage is that the stock only has to rise a moderate amount to breakeven which given the current volatile conditions is a more achievable outcome. The second benefit is that the strategy can be priced so that the Investor does not have to pay any more money to repair their investment. You can see that this avoids risking more capital in a losing position. The last benefit is that you do not need to pay for any margin on the strategy as the existing stock covers the extra sold call as above.

Of course when using options, the Investor has to sometimes forgo additional profits if the stock rises higher than the sold calls. In this example if BHP keeps increasing in price our Investor has capped his maximum profit potential at \$1000. However with the volatile nature of our market at the moment, the ability to make even small profits is of great advantage.

Andrew Baxter is a Director with Halifax Investment Services.

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CAUSE & EFFECT

By Daren Markisic

We look at cause and effect relationships in one of the biggest markets in the world, US Treasury Bonds. Also called T-Bonds or long bonds, due to their time to maturity, which is generally 30 years. US T-Bonds have a coupon payment every six months like US Treasury Notes, or T-Notes, (10 year maturity) with a highly liquid secondary market.

The yield on the spot US T-Bond market is commonly used as a proxy for long-term interest rates, in general. Even though the US T-Note has in many ways taken over this role, the US T-Bond is still an important market.

The futures market, which is derived from the underlying US T-Bond market is also highly liquid and trades in non-serial months, with the main expiry months being March, June, September and December.

Both the underlying cash market and the futures market are directly affected by the US Federal Government Reserve Board (Fed) and US Business Activity financial data.

We now look at the cause and effect relationship between the Fed and the US T-Bonds Market Price, and US Business Activity Financial Data and the US T-Bonds Market Price:

Cause - Fed Activity	Effect on Market Price	Reason for Market Movement
Fed Raises Discount Rate	Decrease	An increase in the borrowing rate for banks from the Fed usually results in increased rates for bank customers. This action is used to slow credit expansion.
Fed Issues Repurchase Agreements	Increase	Fed puts money into the banking system by purchasing collateral and agreeing to resell later. This helps bring interest rates down.
Fed Issues Reverse or Matched Sales	Decrease	Fed takes money from the system by selling collateral and agreeing to repurchase same at a later date. This decrease in the money supply generally raises interest rates.
Fed Buys US Treasury Bills	Increase	Fed permanently adds to banking system reserves which may cause interest rates to drop.
Cause – US Business Activity Financial Data	Effect on Market Price	Reason for Market Movement
Consumer Price Index (CPI) Rises	Decrease	Indicates rising inflation.
Durable Goods Orders Rise	Decrease	Pickup in business activity generally leads to increased credit demand, which may cause interest rates to rise.
Gross Domestic Product (GDP) Falls	Increase	Reflects a slowing economy. Fed may loosen monetary supply, thus prompting a decline in interest rates.
Housing Starts Rise	Decrease	Shows growth in economy and increased credit demand. Fed less accommodating and may attempt tightening by allowing interest rates to rise.
Industrial Production Falls	Increase	Indicates slowing economic growth. Fed may be more accommodating in allowing interest rates to fall to stimulate the economy
Inventory Indicators Rise	Increase	Indicates a slowing economy since sales are not keeping up with production.
Leading Indicators Rise	Decrease	Signals strength in the economy leading to greater credit demand.
Oil Prices Fall	Increase	Reduces upward pressure on interest rates, thereby enhancing prices of debt instruments.

Personal Income Rises*	Decrease	The higher the income the more consumers spend, resulting in increased demand for goods and services and higher prices. *Refer to higher CPI.
Precious Metals Prices Fall	Increase	Mirrors deceased inflation. Demand for inflation hedges dissipates.
Producer Price Index Rises	Decrease	Indicates rising inflation. Demand for goods rises, as do prices. Investors require higher rates of return, pushing interest rates higher.
Retail Sales Rise	Decrease	Indicates stronger economic growth. Fed may have to tighten their monetary stance.
Unemployment Rate Rises	Increase	Indicates slow economic growth. Fed may ease credit, causing interest rates to drop.

Traders and investors need to be fluent in these fundamental aspects of the US Treasury Bond market. Most US business activity data becomes public at 7:30am US Eastern Standard Time (EST), being 12:30am Australian Eastern Standard Time (AEST) or 10:30pm (Australian Eastern Daylight Time (AEDT), with many of the world's leading media agencies reporting the US Business Activity Financial data results.

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