

DERIVATIVES

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COORDINATOR'S MESSAGE

By Ian Flack

This issue is full of great information to add to your trading knowledge.

Daniel Goulding's final instalment of his three articles on options strategies gives us an introduction to using options as insurance for shareholders anticipating a drop in share price. This strategy known as a "collar" can be used to avoid selling shares and creating a capital gains tax event. Thanks to Daniel for his ongoing support.

AIA member Stephen Olsson has written a very comprehensive article on using Exchange Traded Options as an income generation strategy. Stephen's insight into using this method in different markets and the psychology involved in developing a trading plan to suit is very insightful.

Continuing the focus on the use of options Andrew Baxter introduces the strategy known as the credit spread and the reverse strategy the debit spread. This strategy is another method of using options to profit from the market. The strategy allows traders to know exactly how much they can profit or lose before they initiate the trade.

The final article in this issue outlines using CFD's to hedge your share portfolio. Donahue D'Souza explains how to do this using the Macquarie trading platform.

We are always looking for new contributors. If you have a trading strategy, we'd love you to share it. Please contact Silvana Eccles at silvana.eccles@investors.asn.au.

I hope you enjoy this month's bulletin.

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: THE COLLAR AS FREE INSURANCE

By Daniel Goulding

This article is the third 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 a collar.

This strategy entails an investor selling a call option to finance the cost of purchasing a protective put option. A collar is essentially equivalent to free insurance. I will presume that readers are familiar with the subject matter covered in both articles one and two so that there will be no need to cover old ground with respect to selling a call option to generate income or buying a put option for insurance.

A collar can be contemplated by an investor when they are confident that a moderate decline is on the cards but do not want to sell their underlying shareholding. They could consider purchasing a put option for insurance against downside risk but this strategy is not always expedient. If the market has been entrenched in a significant downleg for a period of time, implied volatility may have risen to a point where the cost of buying a put option for insurance has become prohibitive. It is also possible that the investor simply does not have the required funds upfront to make a purchase. In these instances, a collar may prove attractive, providing significant protection against downside risk for a small cost, if any.

For example, an investor with 1000 shares in Woodside Petroleum (WPL) trading at \$45.00 is confident that the stock is vulnerable to a moderate pullback in the near-term. They are sitting on a large capital gain so they do not want to sell the underlying shares and generate a significant tax bill, but they do want to take advantage of the anticipated decline. As a result, they implement a collar consisting of the following transactions:

Sell 1 WPL July 2009 45.00 call @ \$2.95 (receive \$2950 in total)

Buy 1 WPL July 2009 45.00 put @ \$2.85 (pay \$2850 in total).

The combined effect of the above option transactions is to replicate the risk-return profile of the underlying shareholding, but in the opposite direction. Ultimately, losses (gains) on one side of the equation will be offset by gains (losses) on the other side of the equation, albeit not completely. While the collar can usually be implemented for a small credit, there are circumstances when it involves a small cost to the client. In the example above, the investor was paid \$100, excluding transactional costs, to take out free insurance below \$45.00 till expiry.

If WPL drops in-line with expectations, the investor can close out the combined option position, buying back the sold call option and selling the bought put, for a profit. Let's say, for example, WPL falls to \$35 at the end of May at which point the investor decides to close out his option position. The relevant transactions are below:

Buy 1 WPL July 2009 45.00 call @ \$0.15 (pay \$150 in total)

Sell 1 WPL July 2009 45.00 put @ \$9.9 (receive \$9,900 in total).

Taking into account the \$100 the investor received upfront, the investor has made a profit of \$9850 on the option position, closely matching the \$10,000 loss on the shareholding. In this instance, the free insurance has served them well.

If, on the other hand, WPL rises significantly, contrary to expectations, the investor will have to close out the option position at a loss; otherwise they will run the risk of being exercised and having to sell their shareholding. Let's say, for example, WPL rises to \$55 at the end of May at which point the investor decides to close out their option position. The relevant transactions are below:

Buy 1 WPL July 2009 45.00 call @ \$10.60 (pay \$10,600 in total)

Sell 1 WPL July 2009 45.00 put @ \$0.20 (receive \$200 in total).

Taking into account the \$100 the investor received upfront, the investor has made a loss of \$10,300 on the option position, closely matching the \$10,000 gain on the shareholding. If the client is not in a position to buy back the sold call option, they must either roll the call option forward (which is outside the scope of this article) or simply let themselves be exercised, resulting in the sale of WPL @ \$45.00. In light of this possibility, the investor must be comfortable with the potential sale of shares at the exercise price of the call option. If they are uncomfortable with such a possibility, they should consider another strategy, possibly the purchase of a put option for insurance or alternatively, the outright sale of their shares.

While a collar can prove a terrific tool for many investors, like any other strategy, it has its own pros and cons. A prudent investor should consider both sides of the coin before implementing this strategy or for that matter, any other strategy.

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.

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MY ETO STRATEGY

By Stephen Olsson

For the last 12 years or so, I have used Exchange Traded Options (ETO's) as a method of income generation. The method I use is to write uncovered or naked put options on specific stocks or the ASX 200 index and I receive a premium for taking such a risk.

As there are ETO's expiring every month, the strategy I adopt is to write puts in the current month, with the hope that these expire worthless at option expiry, thereby enabling me to pocket the premium received and write new contracts the following month. When the strategy works, this provides a regular income month after month.

The strategy is easier understood by way of example. At the time of writing (29/5/09), BHP is trading around \$34.75. The June expiry put option for BHP with a strike price of \$30 has traded today at 19 cents. What this means is that someone is prepared to pay 19 cents per share for me to take the risk of BHP falling below \$30 in the next month. If I see this risk as acceptable, then as each contract is for 1000 shares, I would receive \$190 for taking that risk. The downside is that if BHP does fall below \$30, I need to be willing to pay the \$30,000.00 necessary to purchase the stock. In reality, the approach I adopt is like being an insurance company, whereby I receive a premium for providing the option purchaser with the insurance of a minimum sale price for their stock in the event the share price falls.

I was first introduced to options trading by a broker friend. I had always been interested in the stock market and I tend to follow fundamentals rather than technical analysis. Therefore I found that I could value the fundamentals of individual stocks, as well as get a feel for the trend of the market, however I couldn't "pick" stocks and successfully trade them for gain in the short term. I am a long term "buy and hold" value investor by nature. The options trading gave me a way of generating an income stream by utilising the skills I had without needing to pick short term price movements in stocks. The best advice my broker gave me was to only write puts at a strike price at which I would be prepared to buy the stock. That has proved good advice over the years. Consequently, I tend to write contracts at strike prices well below the current market price, and therefore receive lower premiums due to the lower risk involved.

I find this ETO strategy to suit my lifestyle and personality type. I have a young family, and consequently limited time to devote to the markets. My strategy doesn't require watching the stock market all day although at a minimum I do check the market and my positions every day. I am also quite analytical and rational in my thought processes, which suits the type of trading. Emotional trading doesn't tend to deliver positive results. I probably spend between 10 and 20 hours a week on my ETO strategy, but I can vary this amount of time to suit other commitments, by adjusting the number of positions I hold open at any time. All ETO contracts can be viewed online through most brokers such as CommSec, and can be traded online as well. However, "market makers" often only provides quotes when requested by brokers, so in practise I find that using a broker and placing trades by phone is the most effective method.

Naturally, there is a reasonable amount of risk involved in the strategy I adopt. My approach works well in a bull or stable market. It becomes much more difficult and riskier in a bear or volatile market. Hence the last 18 months or so have been quite challenging, and I have learnt a lot and had to change my trading strategies over that time. Over the years, the key things I have learnt about trading ETO's are;

1. Discipline is key. Due to the leverage involved you can probably write positions with a market expose of \$1million with as little as \$50,000.00 cash or security lodged as collateral cover with your broker. That is all good until the market turns and you need to come up with that \$1million and you don't have it. Therefore self discipline is needed to make sure you only write as many positions as you can afford, as the brokers are happy to just keep taking your orders as long as collateral cover is there.

2. Have a valuation methodology to value individual stocks and write puts at or below that strike price. Don't chase the market and write options at higher strike prices to obtain higher premiums. Write options at a price and for a volume of shares you are prepared to own in need.
3. Have a trading plan including some "stop loss" strategies. When the market turns against you emotions come into play. This is when you need some set trading rules to follow, and you need to follow them. Sometimes you need to take a loss, and often a small loss now prevents a bigger loss later.

This type of trading obviously isn't for everyone, and some would perceive it as quite high risk. However as stated it suits my lifestyle and personality. I enjoy the challenge and find it fun – that said it is more fun when you are making money, and there have been times over the last 18 months when it has been no fun at all. However, I suspect that has been true for just about every type of investor over that same period. I hope this has given some insight into an ETO strategy that maybe useful to some other investors. I would be happy to provide more details to anyone interested. Good luck and successful investing to all members.

Stephen Olsson is a member of the AIA.

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TRADING THE TREND

By Andrew Baxter

The beauty of options trading is that you can use a multitude of strategies to make a profit. One of these is the credit spread and it is used by traders to profit from a stocks underlying trend. A credit spread is where you sell and buy calls or puts to receive a net credit from the strategy.

For example, we saw an opportunity to sell a credit spread with calls over Commonwealth Bank (CBA) shares on Monday the 11th of May. With the stock price at \$36.74, we entered the following trades:

Sell 10 CBA May \$38.00 Calls @ 45 cents

Buy 10 CBA May \$38.50 Calls @ 32 cents

After doing this we received a Credit \$1300, before brokerage.

The essence of this trade is that we were bearish towards CBA shares. We have a sold position at \$38.00 and we bought a call at \$38.50. This means that as long as CBA stays below \$38.00 by the end of expiry day for May (28th), both positions would expire worthless and we keep the total credit.

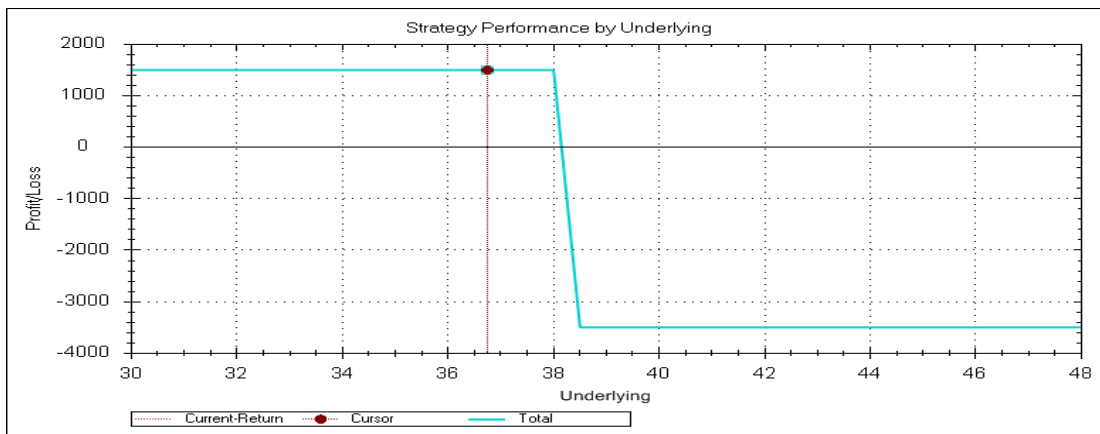
The credit spread relies on the time decay of options to achieve maximum profit. It is ideal when the trader is mildly bearish (for Calls) or mildly bullish (for Puts). Time decay increases towards expiry day and we only had 13 trading days to expiry.

With a credit spread the maximum loss is limited to the difference between the two strikes minus the net premium, whereas the maximum gain is limited to the net premium received for the position, which is the premium received for the short call minus the premium paid for the long call.

The worst scenario for our position is for CBA shares to finish higher than \$38.50 on expiry. This would result in us having to buy the \$38.00 calls and simultaneously sell the \$38.50 to close the position. We would have to pay at least 50 cents to do this (this represents the entire spread between \$38.00 and \$38.50) and we would lose a total of \$3,700.

Given that we received \$1300 to enter the trade and the risk is for 10 contracts over a 50 cent spread, the most we could lose is \$5000, less the \$1300 received initially.

Below is a payoff diagram to show the risk/ reward parameters for the trade. With a credit spread the effect of time decay works well for our strategy. As long as CBA stays below \$38.00 we can comfortably wait until expiry.



However, we only had to wait for one week before the trade could be closed for a profit. CBA shares had fallen to \$35.35 which was \$1.39 lower than when we entered our credit spread. This meant that the spread had fallen in value to allow us to close the spread for a cost of 4 cents. With the stock price at \$35.35 we did the following trades:

Buy 10 CBA May \$38.00 Calls @ 10 cents

Sell 10 CBA May \$38.50 Calls @ 6 cents

This meant we had to pay \$400 to close the position, before brokerage. We were able to make a profit of \$900 in one week (excluding brokerage). Our total risk was \$3,700 (difference between the credit received and the total spread) which meant we made a gross profit of about 24% on our credit spread before costs.

The use of credit spreads is for the trader who is confident they can manage the risk of spread trading. The trader could also use a debit spread which is the reverse strategy of credit spreads. The main difference is that the debit spread relies on the share price to move to make a profit whilst the credit spread relies on time decay.

The limitation of trading spreads is that you have capped your profit from the outset. There is no way you can increase your profit unlike the simple act of buying Calls or Puts. However while the credit spread limits the profits it also minimises losses. The safety of the bought option allows the trader to know exactly how much they will make or lose before the trade occurs.

Andrew Baxter is a Director with Halifax Investment Services.

USING SHORT CFDS TO HEDGE YOUR SHARE PORTFOLIO

By Donahue D'Souza

Often an investor will hold a positive long-term view on a share in their portfolio, but may worry when faced with short-term volatility. This situation may arise ahead of a trading update or a quarterly, half yearly or annual profit update. One way to protect your shares is to use Macquarie CFDs. Macquarie CFDs are a simple and cost effective way for you to protect the shares you hold in your Prime Facility against a contrary movement in price.

The Strategy

A long position profits when the share price moves up and a short position profits when the share price moves down. If you have an equal quantity of long and short positions in the same share in Macquarie Prime, it doesn't matter what the price does - no profit or loss will be generated. You are said to be "fully hedged" against future share price movements.

This strategy involves entering an equal and opposite CFD position to your shareholding. For example, if you hold 539 shares, you could open a short CFD position over 539 shares.

The CFD position will neutralise your equity risk by giving you an equal but opposite exposure to the same underlying share.

The Benefits

Integration

CFDs are fully integrated in the Trading Platform, so if you borrow to purchase the shares held in your Prime Facility, no additional margin is required for this strategy.

CFDs have no set expiry date

As CFDs have no set expiry you are not committed to hedge for a fixed term. You can hedge a share position for the duration of your choice.

CFDs have no minimum parcel size or strike price

Unlike some other derivative instruments, CFDs do not require a fixed quantity or parcel. You can open a contract for any quantity, which enables you to tailor the hedge to your portfolio. CFDs are Direct Market Access, so there is no strike price to select.

Example

This example illustrates how an existing \$85,600 long share position can be protected by opening an \$85,600 short CFD position. It doesn't matter if the share price rises or falls, because all profits/losses will net to zero. As the share price drops in value, the CFD position profits. The profit on the CFD matches the amount that the shares have decreased in value.

	XYZ Share Position	XYZ CFD Position
Direction	Long	Short
Quantity	3,200	3,200
Price Hedged	\$26.75	\$26.75
Value	\$85,600	\$85,600
Current Price	\$24.75	\$24.75
Value	\$79,200	\$79,200
Profit / (Loss)	(\$6,400.00)	\$6,400.00

You should note that this example is illustrative only. Actual returns may differ materially. The example does not account for tax or fees and other costs. It is not a recommendation to make any investment in any share, and should not be taken as personal advice. With a Macquarie Prime Facility, you are responsible for selecting the share for any position you take out. As such, the performance of any share position or CFD will depend mainly on your own investment decisions.

Please note that this strategy is not a “perfect” hedge. In some circumstances, long and short positions may not be adjusted symmetrically as a result of corporate action (eg. The value of a long position may not be increased as much as a corresponding short position is reduced). You should monitor your positions carefully and may need to adjust them to maintain a “neutral” economic position.

Donahue D'Souza, Macquarie Securities Group, Macquarie Bank Limited.

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