AUSTRALIAN INVESTORS' ASSOCIATION

Email Bulletin

Investors Helping Investors

Issue 47: August 2009

DERIVATIVES

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COORDINATOR'S MESSAGE

By Ian Flack

I hope those of you who attended the conference found it full of stimulating sessions.

Please email through your ideas for future articles if you have any areas you would like explained.

This month we have decided to revisit some of the best articles from early editions of the Derivatives Bulletin.

The first is a very good introduction to futures trading by Brian Costello. Brian is a very experienced trader and teacher and his article is a must for anyone new to futures trading.

I have also chosen a series of four articles by Graeme Morgan explaining the use of share futures. These articles are from 2002-2003. The techniques explained are as relevant as when they were written. They can also be adapted to CFD trading.

I noticed when looking at the early issues that many articles were written by members. Please do not hesitate to submit an article for publication. The article can discuss how you trade derivatives. It may also relate your own trading successful or otherwise. You may also wish to ask a question, the answer to which will assist you and many other readers. If you would like to contribute, please send any articles or questions to me at ian.flack@melbournefc.com.au.

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.

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FUTURES TRADING

By Brian Costello

Futures trading is the taking a bought position or a sold position in a futures contracts on a recognised exchange, such as the Sydney Futures Exchange (SFE). Futures trading gives investors the ability to control a large investment for a small initial deposit. Accordingly, futures are a highly leveraged investment vehicle.

With a preliminary interest in trading futures, it is common for Australians to have many questions about the Australian Futures Markets. Below are the most common questions and their answers.

These questions may include:

- What is futures trading?
- What is a futures contract?
- How much does it cost to take a position in a futures contract?
- Who are futures brokers, and how can they help me?
- What are the variation and margin calls?
- How do I trade?
- Do I buy or sell?
- How can I minimise risk?
- Do I have what it takes to become a successful trader?

What is futures trading?

Futures trading is the placement of an order to take a position in a futures contract as either the buyer or the seller of an underlying commodity. Futures contracts are originated and controlled by a recognised exchange, such as the Sydney Futures Exchange (SFE). Futures trading gives investors the ability to control a large investment for a small initial deposit. Accordingly, futures are a highly leveraged investment vehicle.

Futures contracts are traded on currencies, market indices and some stocks. One of the highest traded contracts is the Share Price index (SPI). Currently, one SPI contract enables an investor to access the equivalent profit of a rise or fall in the value of a $750,000 share portfolio for a refundable deposit of $2,000. It is possible to earn profits from futures trading on either a rising or falling market.

What is a futures contract?

A futures contract is a legally binding agreement to buy or sell a stated and specified quantity of a commodity, financial instrument, or index at a fixed price sometime in the future.

By definition, a futures contract requires both a buyer and a seller. It makes no difference who comes first, so long as the contract is completed at, or prior to, the expiry date shown on the contract. A bought position is taken in a futures contract when the trader believes the market will rise. The position is then closed-out by taking a sold position within the same expiry period (3 months). If the contract is closed out after the price has increased, the result is profit.

Alternatively, a sold position in a futures contract is taken when the trader believes the market will fall. And, as when buying, the position is closed-out by taking a bought position in a contract within the same expiry period. The profit in futures trading is simply the difference between the price when the position was taken and the price when the position is closed. It makes no difference if the sold position or the bought position is taken first. The profit or the loss will simply follow the "buy low, sell high" objective.

It is this ability to profit from either a rising or falling market that is one of the major benefits of futures trading.

How much does it cost to take a position in a futures contract?

To purchase a SPI futures contract, you will need a security deposit of $2,000. This deposit is known as the initial deposit. It is refundable at the end of the trade.

The initial deposit provides security against the greatest possible market movement that may occur within a 24-hour period. The $2,000 initial deposit is calculated from historical data, and may be increased or decreased by the SFE, according to market volatility. Additionally, you will need sufficient funds to cover daily variation margins.

Who are futures brokers, and how can they help me?

To become accredited, futures brokers must first pass an examination set by the Sydney Futures Exchange (SFE). Following this, they then must gain experience with a member company of the SFE.

Futures brokers, like people in any walk of life, range from the commission driven, to the genuine relationship builders. Obviously, all futures traders should aim to build a good relationship with this latter type of broker.

The normal brokerage fee for the sale and purchase of SPI contracts ranges from $20 to $50 for each transaction. However, some brokers do charge more. Before accepting this extra charge, you should carefully examine whether these fees are justified.

It's natural for new traders to rely upon brokers for guidance. However, this usually leads to mediocre results - not because the broker is incompetent - but because the broker is unable to monitor trades as closely as an individual can.

Consequently, it is essential for each trader to make his or her own trading decisions, rather than rely on the broker's advice (although your broker's opinion can be sought and considered). This makes the trader - not the broker - responsible for the outcome of each trade.

What are the variation and margin calls?

A variation margin is the number of points the SPI gains or loses daily. At the close of each day's trading, any profits (or losses) are credited (or debited) to your account. If your account balance can't absorb the losses, you'll be required to add funds to your account. This is known as a margin call. If funds aren't forthcoming, your broker may close-out the position. This close-out enables the broker to recover any shortfall from the initial margin.

How do I trade?

Placing a trade is as simple as picking up the telephone and asking your broker to buy or sell a contract. At the time the order is placed, the broker should be given a stop-loss order. This order will limit your losses if the market moves in the opposite direction to that which was initially anticipated.

A number of trading strategies require a position to be taken (subject to the predetermined criteria) and closed out at, or prior to, the close of trading. This is known as day trading. Day trading generally requires the market to be closely monitored throughout the day. This is best achieved via a live screen (expensive) or a pager (about $180 a month).

Another common trading strategy is to take a position and then hold it until certain predetermined criteria are met. Stops are used to protect the trade, and the position is closed-out when the exit criteria are met. This is known as position trading. Position trading has two advantages. First, the market doesn't need to be monitored continuously. And second, it allows the trader to engage in normal employment.

Do I buy or sell?

The greatest concern for most new traders is predicting market trends. There are two main methods used by traders to determine likely market direction: fundamental analysis and technical analysis.

Fundamental analysis involves the study of the basic economic factors that underlay market action. Shifts in interest rates, the release of economic data, movements in the economic position of other countries, movements in commodity prices, and average P/E ratios of the underlying share market are just a sample of many factors that may influence price movements.

Technical analysis is the study of the reactions of traders to past events. This is usually achieved through the examination of chart action. Many technical analysis tools are available. These include: moving averages, Dow Theory, Gann Theory, Elliott Wave theory, Point and Figure charts, Candlesticks and Oscillators.

How can I minimise risk?

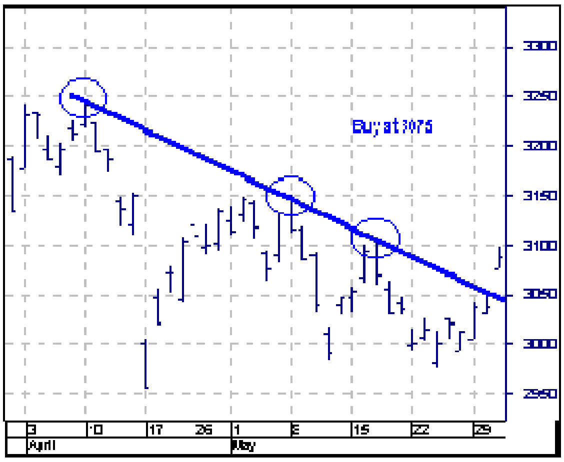
Before you can earn consistent profits trading futures - without excessive risk - you need to learn as much as possible about the trading environment. Obviously this takes time, and an ongoing commitment and desire to learn the intricacies of the futures markets. For the novice trader, the first 6 to 12 months should be a cautious learning experience. While a small trading profit may be nice (most often probable), the sole objective should be to increase your knowledge and confidence about the futures markets.

Only once this confidence and understanding has been gained, should you increase the size of your trades - harness the power of leverage - and consequently, earn consistent profits trading futures.

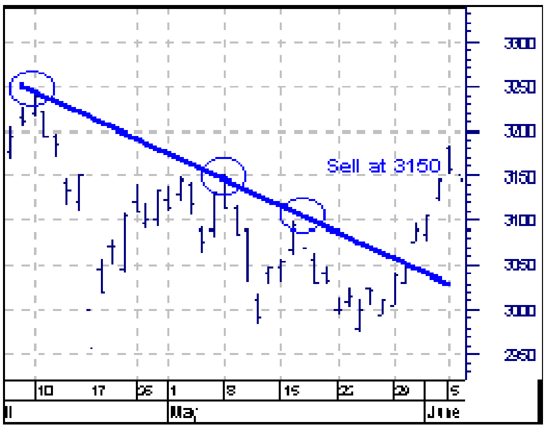
Do I have what it takes to become a successful trader?

A highly successful trader is both dedicated and professional. Additionally he or she will adopt (and follow) a specific trading strategy with unbending self-discipline. A successful trader will never perform a trade based on a subjective or emotional decision.

An example of a futures trade



- Price breaks above a confirmed line of resistance
- Ring the broker and place an order to **buy one June SPI contract at market**.
- Broker advises that the position has been filled at 3075



- Rising price reverses

- Ring the broker and place an order to **sell one June SPI contract at market**

- The broker advises that the order was filled at 3150

- The trader now has no exposure to the market

- The result of the trade was a gain of 75 points during the five days

- 75 points at $25 per point is a profit of $1,875

Below is a list compiled by the National Institute of Financial Studies that highlights characteristics common to all successful traders. A successful trader:

- Has eliminated the bias of fear and greed
- Trades objectively with firm self discipline
- Goes with the flow and trades with the trend
- Accepts the market is always right and cuts losses promptly
- Is unflustered and prepared for any market event
- Continues to learn
- Continuously maintains good money management techniques

Futures traders have the potential to produce huge returns through the leverage available. The art of trading futures is the ability to harness this energy and to use only as much as is appropriate to the circumstances and state of development of the trader.

***Brian Costello** is the Managing Director of the National Institute of Financial Studies. This article first featured in an AIA Derivatives Bulletin in March 2004 (http://www.investors.asn.au/downloads/sigs/Derivative/DerivSig0403.htm).*

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THE NEXT BIG THING – INDIVIDUAL SHARE FUTURES EXAMINED

By George Morgan

There is a Financial Product trading quietly at the moment, just waiting to be discovered by the investment community. It is futures contracts on a parcel of shares in any one of the top twenty stocks on the Australian Stock Exchange. These contracts are called Individual Share Futures (ISF's) and are traded on the electronic trading platform of the Sydney Futures Exchange, much the same way as the shares themselves are traded on the ASX platform SEATS. As a share investor or trader you may not know much about Futures. I hope that the enormous potential in this product will soon become apparent as I explain them fully.

Firstly, what actually is a Futures Contract?

It is really quite simple. A futures contract is a contract to buy or sell something. In this case it is a parcel of 1,000 shares in one of the big companies, let's say BHP. The delivery date on the contract is set at some time in the future, but the price is fixed now. Very simple, but from this simple concept has grown a very powerful investment vehicle. Traders open an account with a futures broker and they can either deal in the contacts directly from their computer or over the phone. An active share trader will find many advantages in trading these contracts. Let's look at a few of them.

Get a Little Leverage in Your Life

Every investor knows what leverage or gearing is and most realise that you need a certain degree of it to really make good returns. Leverage enables you to control the full value of an asset without having to pay for it completely. You normally put up some proportion of the asset's value and borrow the rest. If you want to buy 1,000 BHP share at $10.00 a margin lending account will lend you 60 per cent of the value of the shares and so you put down $4,000 and borrow $6,000 to own

the shares. You pay interest on the $6,000 you have borrowed and get any dividends payed by the company. If the price of the shares goes up to, say $11.00, you make the full paper profit of $1,000. This equates to a 10 per cent gain in the share price but a 25 per cent gain for you, since you only paid $4,000. Let's say after a month you sell out and take the profit.

If you buy a BHP Share Futures Contact for the same 1,000 BHP shares at $10.00 you don't actually own them but rather you have agreed to take delivery of them and pay the full price at a set date in the future. You have to lodge a security deposit, called a 'margin', of $775. You pay no interest on the remaining $9,225 of value of the shares. If the price goes up to $11.00 you can then sell your Futures Contract at that price and you earn a $1,000 profit that represents a 129 per cent gain. Obviously increased leverage is a powerful tool but it should be used wisely as it can also create a larger percentage loss if the shares go down.

Liquidity

Another major factor in favour of the futures markets is that generally they are very liquid. This means they have a high volume of trades and so it is always easy to get in or out in an instant. Normally if you have relatively limited funds and wish to trade shares you find yourself at the small end of the market. You are typically limited to companies whose shares are trading in the 10 cent to 50 cent range. While these shares can show good movement they are typically rather thinly traded. This lack of liquidity means that you may get caught in a situation where it costs you a couple of cents movement in the share price just to get out.

What Happens if the Market Falls

Let's say that instead of going up to $10.00 the price of BHP shares actually falls to $9.00. If you bought you would be showing a loss, but perhaps you may have correctly anticipated the drop. This will illustrate one of the real advantages of using ISF's to trade the big stocks.

I said earlier that a Futures Contract is a contract to buy or sell. You can enter a contract to sell the shares and deliver them in the future at a price agreed on today. Obviously if you think the price is going down and so it is too expensive today you can take a contract to sell at today's high price. Of course if you still have the contract open you will have to deliver the shares on the day and be paid the full price of the contract, not the market price on the day. So you could buy the shares at the prevailing market price of $9.00 and then deliver them and be paid the $10.00 thus making $1,000 profit on the falling price. In practice you simply buy back the contract at $9.00 and make the same profit. Of course if BHP goes up to $11.00 you would buy back your contract at a $1,000 loss.

When you enter a contract to sell in the future, it is called going 'short'. Entering a contract to buy is called going 'long'. It is equally easy to do either.

The ability to go short is a key concept in futures trading When trading the shares themselves, going short is a lot harder than buying since the broker has to lend you the shares. Some brokers either actively discourage the practice or simply don't do it. This has the effect of locking the share trader into being a bull and always looking for the market to go up, and we know that just doesn't happen. There is an old saying that the market goes up by the stairs and down by the elevator. Short trades often happen a lot more quickly than long ones. We are now starting to talk like a futures trader and so here is something that all traders love to hear:

Low Transaction Costs

Buying and selling $10,000 worth of BHP on the futures market will cost you $21.50 brokerage in and the same to get out, plus GST and with no Stamp Duty. This equates to a very low 0.215 per cent, which isn't bad at all.

Movers and Shakers

Another problem an active trader may face is when you buy a particular share and it just goes to sleep. This can be frustrating and if you have bought options, either puts or calls, it can cost your real money, as you watch the time decay bleed value from the option's premium. This rarely happens when you trade ISF's because the shares they cover are the movers and shakers of the Australian Stock Exchange. They are the large capitalisation stocks and provide a great trading medium because they are volatile and thus provide opportunities on the long and short side of the

market. They can be too expensive to be traded outright by many investors but using Individual Share Futures give the leverage to trade them in meaningful quantities.

In the next issue I will discuss strategies to use Individual Share Futures for trading and for protecting your portfolio against a market fall.

George Morgan is the Managing Director of George Morgan Futures and has been a trader since 1983. This article first featured in an AIA Derivatives Bulletin in September 2002 (http://www.investors.asn.au/downloads/sigs/Derivative/Derivsig0209.htm).

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HOW TO USE INDIVIDUAL SHARE FUTURES

By George Morgan

The June Queen's Birthday long weekend of 2001 was a very significant time in the history of the share price of Telstra Corporation. In the week prior to that weekend, the price broke to the up-side from a period of consolidation and looked like it was heading much higher. The Friday closing price was $6.72. Over the weekend the Chief Executive Officer, Ziggy Switkowski made a shock announcement. Profit performance was to be downgraded. The market reacted savagely when trading resumed on the Tuesday. The stock opened at $6.28 and traded as low as $6.05, closing at $6.08. The bar chart below tells the story.

TELSTRA CORPORATION DAILY BARS

Let's look at this situation from a few different points of view and use it to show us how different people would fare using Individual Share Futures.

The Speculator

To the trader, such a situation is manna from heaven.

You see, futures markets were set up to enable participants to minimise their risk, that is to hedge themselves against such a drop in price. However the markets have evolved into such an efficient forum for trading that speculators today generate probably ninety percent of the activity in them.

The word 'speculate' comes from the Latin speculari that means to spy out and observe. I prefer to use the term 'trader'.

You form a judgement of what you believe will take place and then you make a move in a market that tests that judgment. If you are correct you make a profit, and if you are wrong you lose.

Let's say our speculator in the above situation has a medium size account with a futures broker of say, $30,000. He is aware of what has happened and decides to move aggressively, risking a full ten percent of his trading capital. He believes that the chart shows a classic 'bull trap'. This is where people would have bought anticipating it was going up and would now be in a hurry to sell and so dump the stock. This would cause a calamitous drop in price.

On the Tuesday morning he phones his broker and places an order to sell 15 contracts of July Telstra Futures at the market on open. This represents 15,000 shares. He is filled at $6.25 and places a stop-loss order at $6.45. This means he will be automatically closed out if the share goes up to that price giving him a loss of 20 cents per share, or $3,000. He also sets his profit target of $1.00 per share, or a price of $5.25.

The shares in fact trade up into the mid-$6.30's giving him some concern but they fail and trade down to their lows. Our speculator holds his position and takes his profit $1.00 lower at $5.25. On the chart you can see that level was reached about three weeks later. This represents a profit of $15,000, minus Commission.

On the other hand, of course, if the stock staged a recovery over the days after he sold it, he would have lost the $3,000 plus Commission. In fact he probably would have lost slightly more because the Stop-Loss order is executed at the market price. This means it would have been filled at say, $6.49.

This is a nice little trade and there are a lot of lessons built into our example.

The Hedger

What if you were a long-term holder of a large parcel of Telstra stock? What would be your options if you didn't want to dump your holdings?

I will discuss this in detail in my next article.

George Morgan is the Managing Director of George Morgan Futures and has been a trader since 1983. This article first featured in an AIA Derivatives Bulletin in October 2002 (http://www.investors.asn.au/downloads/sigs/Derivative/Derivsig0210.htm).

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HEDGING YOUR PORTFOLIO AGAINST RISK

By George Morgan

In the last two articles we have had a look at Individual Share Futures (ISF's) and a trade using them. Now I would like to talk about how to use them to protect yourself against a sell-off of the shares in your portfolio.

'Hedging' is a term that is often wrongly used. It means to seek to cancel out the risk in a situation, such as "hedging your bets". The term 'hedge fund' applies to a class of investment that has very little to do with hedging and so is a real misnomer. A hedge fund is actually a highly speculative fund that invests in virtually anything in order to make a profit. They are international and so are not highly regulated. They attract wealthy investors who are seeking a high risk, high reward strategy. Globally their combined assets reached a staggering US$600 billion in 2001.

The traditional meaning of hedging is what the futures markets were originally designed for. For example, a wheat farmer can sell his crop of wheat on the futures market for a guaranteed price as he is planting it. Not only does this remove uncertainty in his return but also it enables him to borrow the funds to plant the wheat since the lender can be assured of his return also. Someone who sells his product overseas may also wish to protect himself against a falling US dollar.

Unfortunately most hedgers in Australia, particularly in the US Dollar, tend to use 'Over the Counter' options which I believe are unnecessarily complex and expensive and rather hard to get out of. Once you have a hedge in place you are effectively locking in the price so that if the price moves in your favour you don't get the benefit.

This brings us to the point - no one wants to be hedged when prices are moving in their favour. Therefore you need a hedge that is cheap and easy to get into and out of, depending on your view of the likely market movement.

Let us go back to our example in the previous article. Remember that fateful June long week-end in 2001 when the Telstra share price was dealt a savage blow by a dose of earnings reality? The price closed on the Friday at $6.72 and opened on the next trading day at $6.28. Let us say you had 20,000 Telstra shares in your portfolio. You believe that it is not the whole market collapsing but only this specific stock. You ring your futures broker and place an order to sell 20 contracts of Telstra Share Futures and are filled at say, $6.18. In this case that is all you needed to do. You have effectively locked in that price for your shares.

All you have to do is 'roll-over' your futures position to maintain the hedge. That means that before the futures contract expires and you are required to deliver your shares you simply buy the contracts back and sell the next futures contact. For example, if the first contract you sold was a September contract, sometime in September you would probably buy back that contract and simultaneously take a contract to sell in December. This maintains your hedge and keeps your hedge price approximately locked in. The only direct cost is the commission to get out of the expiring contracts and get into the longer dated ones.

In this example that would have given a good result. Your Telstra share price would have been locked in at over $6.00, with the market price currently being at $4.52 as at the close of business on November 28th 2002. Around that date you may even decide that the share price has bottomed. You then lift your hedge by buying 20 Telstra Share Futures at $4.58. This gives you a gross profit of $32,000 before brokerage. You still own the shares and you still have received all the dividends payed by the company during the period.

Of course, there is no free lunch. There are potential drawbacks to hedging. If the price of Telstra had bounced from there the result would have been very different. Let's say that some major good news for the company broke in the following weeks and the price jumped sharply. Here is the beauty of using pure futures to hedge. If this happens you simply close the position by having what is called a stop loss order resting with your broker. You might judge that if Telstra trades through $6.40 again you are wrong and the price is heading back up. It does so and your stop loss 'buy' order is filled at $6.45. You take a loss on your futures contacts of 27 cents or $5,400 plus Commission. This would be pretty much the worst case scenario.

Another bad situation would be if the price fluctuated around the level you decided was critical to hedge. This would mean you would probably be placing and lifting the hedge quite a few times. This would chew money up in commissions and small losses until the price moved decisively one way or the other so you could either be fully hedged, or not hedged at all.

Like most things in trading, Hedging requires that you form a view of what is likely to happen in the short to medium term. In my next article I will detail some advanced strategies using Individual Share Futures and take a close look at a few of their other features.

George Morgan is the Managing Director of George Morgan Futures and has been a trader since 1983. This article first featured in an AIA Derivatives Bulletin in December 2002 (http://www.investors.asn.au/downloads/sigs/Derivative/Derivsig0212.htm).

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POSTCARD FROM THE TRENCHES

By George Morgan

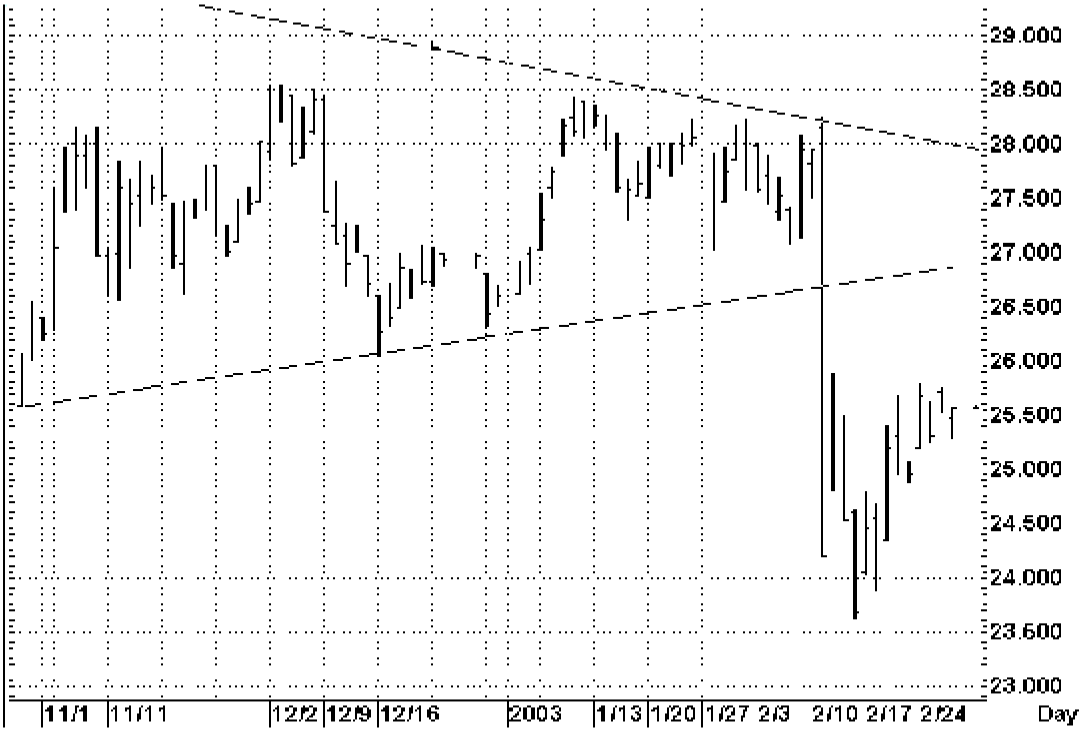
Trading the markets is often compared with doing battle or being in a war. In my previous articles I have spoken about Individual Share Futures and now I'd like to tell you about some of the trades we have been doing with them lately, some 'war stories' if you like. I use the term 'we' to mean one or more of our clients.

Short the Banks

This has been the best trade to come along in a long time. It has been virtually pick a bank and sell it to establish a short position. We sold CBA on a break of $27 and again on a break of $26, and we sold ANZ when it re-tested $17.00 after breaking through that level. We are still holding these positions.

Wesfarmers

This is an interesting trade that shows you can trade very short term. On 11 February the market for a perceived failure to meet profit targets savaged this stock. As you can see from the chart it fell from $28.25 down to $24.20. A few days later it had a strong up day and closed above $25. We bought 10 contracts (10,000 shares) and sold at $25.50 a couple of days later for a quick trading profit of $5,000 gross.



Wesfarmers Daily Bars

Fosters

We bought this stock at the beginning of the month on the basis of a very strong day's price action and it continues to languish at our entry price of around $4.33.

Mt Isa Mines

We bought this stock at $1.50 with the take-over offer at $1.70 on the table. We bought thinking that the downside risk was limited by the offer, but wound up exiting at $1.61 when the offer was with-drawn.

On the Horizon

We are interested in going short in Wesfarmers now. We have had the major sell-off, some consolidation, and now we are set to continue down. So here is a recommendation to finish up:

Sell Wesfarmers Individual Share Futures at $25.31, which is 20 cents lower than the actual share price.

George Morgan is the Managing Director of George Morgan Futures and has been a trader since 1983. This article first featured in an AIA Derivatives Bulletin in March 2003 (http://www.investors.asn.au/downloads/sigs/Derivative/Derivsig0303.htm).

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