

DERIVATIVES

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COORDINATOR'S MESSAGE

By Ian Flack

In this issue we begin with an article from Michael McCarthy that puts into perspective the use of algorithmic, or automated trading one of the fastest growing trends in Forex trading. Michael points out that these methods still require the trader to follow the same basic principles they would for any successful trading system.

In the next article Brian Sayers gives us some very sound advice on avoiding fraudulent practices when trading the forex markets. His advice is particularly relevant to new traders of currency markets.

Mark Boulton's review of ***OptionsWise how to invest sensibly*** gives potential readers a thorough explanation of topics covered in this book by Wai-Yee Chen. Mark provides an insight into what options trading strategies are covered and that they are particularly relevant as they focus on ASX listed options. He also provides a link to an associated website with lots of useful information.

This issue concludes with a second book review ***Option trading: pricing and volatility strategies and techniques***. Tim Josling suggests this book is aimed at professional traders. Tim gives us a great explanation of what to expect as well as areas that are not covered in great detail. Anyone trading options should read Tim's review before investing in this book by Euan Sinclair.

I hope you enjoy this issue and please provide us with feedback. We aim to make this bulletin responsive to the readers needs. We can only do this if you let us know what areas or topics of derivatives trading you would like covered. Thanks again to our contributors.

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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ROBOTIC FOREX TRADING

By Michael McCarthy

One of the fastest growing trends in Forex trading is the use of algorithmic, or automated trading. The attraction is obvious – who wouldn't like to turn on a "machine" that does all the work and spits out money? Although the development of an automated trading system may be beyond the financial means and/or programming skills of many traders, the benefits of systematic trading are available to all who are willing to apply the principles.

The ideas underlying many systematic trading systems are based on behavioural finance. The theory suggests that the "walk" of markets is not entirely random, and that identification of recurring patterns can lead to potential trading profits. This is the same principal that underlies Technical Analysis, or charting.

Many traders are already using a favourite chart based signal (or signals) for their trading. The power of relying on charts signals is that much of the emotional turmoil associated with trading can be overcome by the mechanical aspects of the trade selection process. Most technical signals allow a trader not only to identify an entry level and a target price, but suggest a level at which the impartial observer can state that the signal has failed. This gives three clear price points – the trade entry, target exit and stop-loss exit.

If we accept that the two key elements of a trading plan are signal selection and money management, a trader can then subject these price levels to their financial disciplines. Can the anticipated entry and exit levels be achieved? Is the ratio of the amount at risk to targeted profit acceptable?

In essence, many successful traders know exactly what they will do, no matter which path the market takes. They have already answered questions of how they will select a trade, what size trade they will put on, how it will be measured against their money management principles, their profit target and when they will accept that it has become a losing trade. Once this trading framework is identified, and with sufficient resources, the trader is ready to automate the trading process.

However, as the trader has already constructed the important aspects of a successful trading plan, automation is not required to be successful. With a plan in hand, a trader needs only:

- 1) Define a trading universe – that is, decide what instruments will be traded, whether it is the most liquid market in the world (EUR/USD) or a collection of lesser known small cap stocks.
- 2) Rule out any over-rides. Once the plan is developed, and the rules of trading defined, the crucial aspect is to stick to those rules. Enter every trade that fits the criteria, honour every stop-loss, wait until each profit target is hit.

If a trader follows these guidelines, and has a signal selection process and risk/reward ratio that are in proportion, the chances of making solid and repeatable profits from the market are greatly increased. In taking personal judgements out of the process, a trader gains all of the advantages of automated trading without the effort or expense of constructing a market facing machine.

As FX markets trade 24 hours a day, and are highly liquid, they are ideal for this style of disciplined, pre-determined trading. Continuous trading (during the week) means that "gap risk" is much lower – there is less danger of slippage on stop loss orders due to markets re-opening at vastly different levels to that at which they closed. The highly liquid nature of Forex markets means that the price is much less susceptible to temporary distortions and "noise" moves, giving traders the confidence to get in and out at the levels selected.

Of course, these trading principles are not limited to chart based signals – they can be applied to any trading situation that can be quantified. For example, if a trader buys AUD/USD on any Reserve Bank of Australia rate rise that exceeds market expectations by 0.2%, this can be

incorporated into a trading plan. Buying retail stocks after retail sales data shows an exceptional monthly increase is another example of quantifiable fundamental signal.

The point is that it is not the robot that makes the money – it is the processes that are put into code that determine the success of any algorithmic trading system. In reality, using a systematic trading method is just a modern way of enforcing the most essential aspect of successful trading – approaching trading in a disciplined manner.

Michael McCarthy is the Head of Dealing, Asia Pacific, City Index, based in Sydney. He has more than two decades of active involvement in the financial markets in various roles with international investment groups such as County Natwest, Salomon Smith Barney, Citigroup and ABN Amro.

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PREVENTING FOREX FRAUD

By Brian Sayers

If as a new investor you are not familiar with the foreign exchange market be warned there are scams out there. Most of these scams are very easy to spot, and even the newest trader can avoid them. Most of the scams revolve around people trying to sell anyone on the internet computer programs that promises to make you money. They advertise huge profits with little cash, and sucker a few people into buying them. There is no program available out there to the public that will work as well as it claims. If you believe that there is an easy way to make money in the financial markets, and specifically the [currency markets](#) you would be wrong. That doesn't mean that through lots of reading and practice that a new forex trader cannot be profitable.

Anyone who wants to be profitable can be with the right work ethic and dedication to trading or investing. It takes hours of staring at computer screens and trying new ideas until you can come up with a method to make money.

Opening a [forex account](#) and learning to paper trade is the first step anyone who wants to learn must take. Through the paper trading of a demo account that many forex brokers provide, the new trader can get a feel for how the market moves. Believe me, the forex market moves up and down and side to side very quickly. If you have prior trading experience you will find the currency markets a bit different from the other [markets that people trade](#) and invest in. Your prior experience will help you to understand the market faster than those who have had no prior knowledge.

Make sure that as a new trader you choose a forex broker that has been reviewed and used by other traders. Looking up the name of the broker online will usually give you a few articles and write ups about the good and the bad. Some forex brokers are very fraudulent and don't even exist. You will give them a deposit never to see it again. There are many reputable brokers that exist to provide you with a place to trade. There should be no reason that the new trader cannot find one that suits their needs. Many brokers these days will include many forex training videos for the beginner. This will help to make you money in the long run. Sit down and take the time to watch the videos that market professionals have put together.

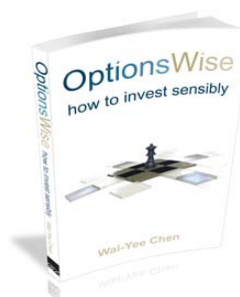
Charting software is also provided, and is a necessary tool for any trader to succeed. Since the forex market is mostly traded by looking at technical indicators, the charting software and studies that they include will be an important factor in your decision. The fraudulent brokers will have little to no software or training videos, so if the broker will not provide you with literature and education it might be best to steer clear. As long as the new trader does his or her research on brokers and the currency markets in general they will not be taken advantage of. One of the best ideas is to go to [the local book store](#) and find a forex trading book in the finance section. This will provide the reader with the basic principles and ideas behind investing in currency. In addition any new trader can read up about forex on investing web sites and open their practice account. After a few months of practice they may be ready to deposit real funds into their account.

Brian Sayers is the Reach Manager for ForexFraud based in the USA.

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BOOK REVIEW - OptionsWise how to invest sensibly

Title: **OptionsWise how to invest sensibly**
Author: Wai-Yee Chen
Publisher: Oex Publishers Pty Ltd, Australia, 2010
ISBN: 9780 9807 15101
RRP: \$27.95
Reviewer: Mark Boulton



Have you ever considered investigating or finding out more about financial options? If so, this book could be a good starting point. If you have an existing financial strategy using options, this book may assist in adding some more strategies to your repertoire. Alternatively this can be a good book to alert you to what is available, and you could find an adviser to deal with the details (hint – the author would likely be a great adviser). By the way this book focuses mostly on ASX listed share options/indices.

There are four general investment mentalities (through following four characters) covered in this book – risk averse, get rich quick, slow and steady, and businesslike. Hopefully one to suit every reader's mindset.

Unless you are already very familiar with options, you could easily get stuck with trying to understand everything in this book in one read. However after quickly reading the book without trying to understand absolutely everything, what I found great was that there is a shopping list of strategies that could be considered for reducing risks, optimising the purchase or sale of shares, or for profiting from a particular view. Once you find a strategy you like, you can to some extent revise backwards to fully understand its basis, and then work forwards to review the risks of the strategy (even including whether your thought process is logical or not). You are not going to need to remember every detail.

There is an associated website www.optionswise.com.au. This has some applications that look like they will be very helpful (maybe nearly mandatory) in assisting you with pricing options and how much cash-margin you will need to put down (even for multiple transactions). One very neat application is the “strategy optimizer” that recommends a strategy based on completing some questions and selection criteria. Be aware that you will most likely not understand these online applications if you have not been familiarised with options.

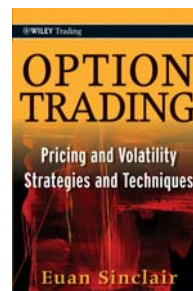
One minor criticism of this book, is that I was looking for more of a bridge from buying and selling shares, through to using options. I would have loved to see a chapter or section dedicated to detailed considerations regarding buying a share versus buying a call option, and selling a share versus buying a put. This is definitely covered – but I would have liked this basic information placed under the microscope a lot more.

This is a very commendable and helpful book, and one that I will certainly refer to from time to time. The author is convincingly very knowledgeable on the topic, and is generous with her experience. This book would certainly give most investors and speculators some more options to consider (boom boom ☺).

Mark Boulton is a member of the AIA.

BOOK REVIEW – Option Trading: pricing and volatility strategies and techniques

Title: ***Option Trading: pricing and volatility strategies and techniques***
Author: Euan Sinclair
Publisher: Wiley Australia, Brisbane, Australia, 2010
ISBN: 9780 4704 97104
RRP: \$92.95
Reviewer: Tim Josling



This book aims to provide professional option traders with a solid understanding of the theory and practice of option trading. The typical reader would be an employee of a bank, a hedge fund or a market making firm that trades options, rather than an individual investor. There is no pretence that this will be an easy read for the 'average person'. A solid knowledge of calculus, including partial derivatives, is assumed, especially in the early chapters on option pricing models.

With these caveats, the book achieves its objectives, providing a good balance of theory and practical information.

The early chapters cover option contracts, and the mechanics of trades, all in considerable detail. The academic theory - the Black-Scholes-Merton and Binomial models - follows. These chapters take the discussion to a level far beyond that of many options books, which simply focus on using options for leveraged bets on stocks or commodities.

The academic theory is important but it is only a starting point, as the assumptions that the academic models make are not always correct. Often the trader's edge appears just where these theories break down. Accordingly, much of the rest of the book is devoted to a detailed analysis of these breaking points, such as lack of liquidity, hedging, scalping, limited market making and arbitrage, the risk of large price jumps, 'fat tail' price distributions, and many others. This may be the most valuable section of the book. In particular the descriptions of price formation and price discovery are very insightful and informative. These chapters make this a marked improvement on earlier books on options trading such as Cox and Rubenstein's *Options Markets*, which tended to stop at the academic theory. Those who place excessive faith in these theories can lose vast amounts of money or even wreak havoc in financial markets, as Long Term Capital Management, run by Nobel Memorial Prize-winning economists, showed in 1998.

Euan Sinclair has previously written on the topic of volatility-based strategies. Consistent with this, Chapter 11 contains a strong section about estimating and pricing volatility, as well as strategies to exploit others' poor estimates of volatility.

Many members of the AIA will be individual investors and this book, while potentially very useful, is not really aimed at them. For an individual investor, two areas in particular stand out that the reader would need to cover in some other way.

The first is psychology. Sinclair is very dismissive of the role of psychology in investing: "Traders do not need to have psychological discipline to stick to their plan. This is laughable." His attitude to this issue may reflect his own background working in large companies. In large companies your risk management people ensure - or should ensure - that you keep your risks within reasonable limits and follow a plan. Without this organisational discipline, the scope for self-deception and ruinous losses, particularly when trading often highly leveraged derivatives, is unlimited. An individual investor needs a strong understanding of his or her psychology and solid practices to ensure that these outcomes do not happen. There is a lot of material on trading psychology in books such as *Stock Market Wizards* by Jack Schwager. Ed Seykota, who has one of the most successful documented trading records of all time, devotes his *Trading Tribe* web site (<http://www.seykota.com>) almost entirely to psychological issues in trading.

The second area is risk management. Chapter 13 covers aspects of risk management, but is mainly concerned with adjusting hedges as prices move and as option expiration draws nearer. The question of position sizing is vitally important but only gets 5 pages of coverage in Chapter 9. Individuals typically overestimate their maximum safe position size by a factor of 20 or more. This is one reason why so many traders "blow up" within the first couple of years. Jarrod Wilcox's book *Investing By the Numbers* has an excellent section on position sizing, and optimising multi-period returns, and the books mentioned above also cover this topic.

In addition, there is not much discussion of options strategies popular with small investors, such as using options to make positional bets, selling covered calls, selling far-out-of-the-money options, and hedging exposures to underlying shares. This reflects the book's focus on the market players who are probably taking the other side of the trade to the individual investor. The book does point out that selling covered calls while owning the underlying stock is equivalent to selling naked put options and that selling out of the money options is similar to selling insurance. Depending on the degree of leverage involved, these can be very dangerous things to do.

Overall this book is a very useful potential addition to the library of anyone who wants to trade options in a serious way.

Tim Josling is a member of the AIA and has been investing for almost 30 years.

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