AUSTRALIAN INVESTORS' ASSOCIATION

Email Bulletin

Investors Helping Investors

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DERIVATIVES

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COORDINATOR'S MESSAGE

By Scott McKenzie

Most of us ignore the possibilities that derivatives (in the cases described here - options), as they are quite complicated and we don't take on anything that we can't understand. This is a position that is lauded in books about investing. Too many people have lost too much money over the years chasing returns in investments that they didn't understand.

And so we continue to miss out on the extra returns that are possible through the wise use of options.

This edition features two strategies we can use, with limited risk, to increase such returns. The first, a put-ratio calendar spread strategy, by Tejay Lovelock (Macquarie) and the second, a protected covered write strategy, by Danny Moss (Vertical Solutions), both have the potential to enhance returns on ASX 200 shares as well as protecting against down-turns.

As we develop an interest in strategies like these we will find Glen Van Ooran (Lifestyle Trader) has provided us with a useful glossary of terms used in derivatives trading.

All of these articles are well worth a look. How about making one of your goals for 2011: investigating how I can enhance my returns using option strategies?

Scott McKenzie is the Vice President of the AIA.

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DIVIDENDS AND FRANKING CREDITS: A STRATEGY THAT MAY ENHANCE RETURNS

By Tejay Lovelock

While some investors focus primarily on generating capital returns, experienced self managed super fund investors will understand the importance of dividends and franking credits.

This article provides an example of a strategy that could be used to enhance investor returns without increasing their downside risk.

Since 1992 dividends on the S&P ASX 200 Accumulation Index have accounted for 35 per cent of the average market return, without taking into account franking credits[1].

Investors that generate income from dividends will understand there are a few hurdles to collecting the franking credits associated with dividend payments:

- Their position must be held continuously 'at risk' for at least 45 days.
- They cannot eliminate more than 70% of their ownership risk.

During the 45 day period the value of the shares can change considerably which may make investing for dividends less attractive.

However, investors often do not utilise their ability to eliminate some of the ownership risk.

A strategy for potentially managing this risk is a put-ratio calendar spread strategy. This essentially means an investor;

- is obligated to buy shares at a specified price in the near future.
- has the right to sell a portion of these shares at a lower price in the distant future.

The key benefit of this strategy is it can significantly maximise investor upside potential if they acquire the shares.

Example Strategy:

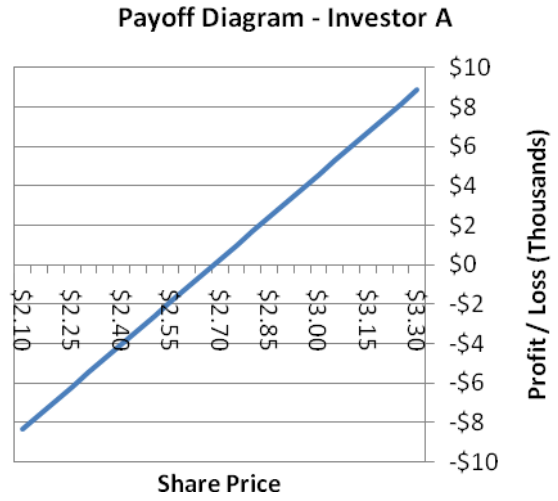
Date range:	3 Dec - 21 Feb
Stock:	TLS
Recommendation:	TLS was neutral and price target $2.95
Investor A:	Buy and Hold TLS
Investor B:	Put ratio calendar spread.

By taking advantage of the dividend and franking credits associated with the dividend payment, this becomes an ideal stock to use for income rather than capital growth.

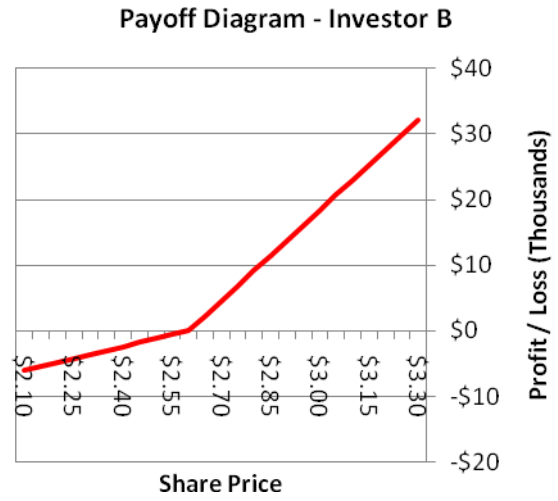
To consider the advantages and disadvantages of this strategy let's compare two investment strategies.

[1] Source: Iress, 16 March 2011

Investor A simply purchased $40,400 worth or 14,326 TLS shares at $2.82. The diagram below shows the payoff for this strategy;



Investor B implements the option strategy and eventually buys the shares after been exercised on the sold put options. The next diagram demonstrates this strategy;



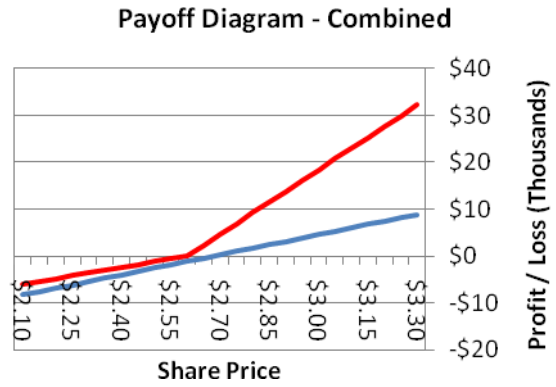
The diagram below compares these two strategies directly (including dividends and franking credits);

	Investor A	Investor B
Capital at risk	$40,400	$40,390
Dividend	$2,005.64	$6,440
Yield 'on at risk $'	**5%**	**16%**
Franking Credits	$859.56	$2,040

This is the option strategy Investor B may implement;

- Sold 46 January $2.80 puts for 6c
- Purchased 34 March $2.60 puts for 7.5c

Investor B would be paid $210 for implementing this trade before brokerage costs and ASX option charges.



At option expiry in January, TLS closed at $2.80 and the shares were purchased.

Investor B paid $128,800 to purchase 46,000 TLS shares. This investment is significantly higher than Investor A, however Investor B has protection in place whereas Investor A does not. Thus Investor B had;

- Exposure to more shares.
- Slightly less downside risk then Investor A.

The investment case may be stronger for Investor B when the 45-day period is finished and the shares are sold along with the March $2.60 puts which may increase returns further.

Typically, this strategy would be implemented for clients who have a +$1m portfolio and hold at least +$150,000 in cash and do not mind investing this spare cash for income. This way the shares can be purchased outright at all times if the investor is exercised on the sold puts.

Investor B faces additional “upside” risk to Investor A in the sense that Investor B is not guaranteed to buy the shares, whereas investor A owns the shares and can potentially profit from an appreciation in the underlying share price.

However, if Investor B is not exercised on the sold puts, interest is still earned on the Investor B’s cash position and a small return may be generated from the trade even before the purchased puts are sold.

In this example, Investor B’s downside risk was always superior to Investor A after receiving the dividend and franking credits. It is important to understand that the downside risk of this strategy is not always superior to a buy-hold approach or Investor A’s. Investors need to asses each investment on a case-by-case basis and wait for the right time to implement a put-ratio calendar spread strategy.

This strategy may have the potential to significantly enhance returns by delivering a superior risk/reward proposition compared to an investor that simply buys and holds for the dividend. However, as stated above this strategy will not be suitable for every investor so they should speak to their financial adviser about how this may meet their needs.

Tejay Lovelock is a private client adviser with Macquarie Private Wealth. He can be contacted by phone 07 5509 1499 or email tejay.lovelock@macquarie.com.

INCOME GENERATING STRATEGIES COLLAR SPREAD (PROTECTED COVERED WRITE)

By Danny Moss

Introduction

The 'Collar Spread' or 'Protected Covered Write' is a very effective strategy that consists of holding stock, writing (selling) a call option above the market price and buying a put option below the market price. To make this strategy effective the goal is to have the credit received from selling the call cover the cost of buying the put – we go into further detail with regards to the mechanics of the trade later in this document.

What are Call and Put options?

Options are a form of derivative (derive their value form the underlying) and can produce returns when the market goes up, falls or stays neutral.

Call options:

- *When an investor BUYS a CALL option they are buying a right to buy shares at the strike price of the option on or before expiry of the option. For this right they pay a premium*
- *When an investor SELLS a CALL option they are making a promise to the market to sell shares if called upon to do so. For taking on this risk the investor will receive a cash premium (income)*

Put options:

- *When an investor BUYS a PUT option they are buying a right to sell shares at the strike price of the option on or before expiry of the option. For this right they pay a premium*
- *When an investor SELLS a PUT option they are making a promise to the market to buy shares if called upon to do so. For taking on this risk the investor will receive a cash premium.*

Why use the Collar Spread?

This strategy is utilised by investors of all levels and experience because it is provides three key elements when wanting to enter into the market:

1. **Generating Income** – Writing an option results in receiving a cash premium
2. **Capital Growth** – Investor benefits from increase in share price
3. **Protection** – Crucial aspect of risk management

In times of high volatility, or in bearish markets, it can be useful to limit the downside risk to a portfolio. Another advantage is that the cost of setting up the options component of the collar can be done at a credit – therefore you end up with FREE INSURANCE. The Collar Spread can also be used when the outlook of the underlying stock is mildly bullish.

Constructing the trade

The investor buys 1000 XYZ shares @37.50
The investor sells 1 x 38.50 Call Option @ 1.35 (1.35 x 1000 = $1350)
The investor buys 1 x 36.00 Put Option @ 0.60 (0.6 x 1000 = $600)
What you will notice here is that the net result of the options transaction is a credit of;
$1350 received from selling the call
$600 spent for buying put protection
= $750 net credit.

What this means is that the investor has created a position in which they have:

- Downside protection
- Room for capital Growth
- Income generation.

Potential Outcomes

Scenario 1

The share price rallies and at expiry of the options XYZ is trading @ 40.00

Outcome

- You will be selling shares @38.50 (strike price) + net premium of 75cents
    - = effective sale price of $39.25
    - = $1.75 profit per share = 1.75 x 1000 = $1750 PROFIT

Scenario 2

The share price falls aggressively and at expiry XYZ is trading @ 33.00

Outcome

- Option 1 - As you have a put option as insurance, this allows you to sell your shares at 36.00 if you choose to do so.
    - This would result in 75cent loss → compare this with the potential loss of $4.50 (4.5 x 1000 = $4500) if you did not have the protection in place
- Option 2 – As the share price has fallen this means that the put option has increased in value dramatically. The put option (which was acquired for free) will now be worth 3.00 and can now be sold
    - = 3.00 x 1000 = $3000
    - In this instance you will have lost money on your share price but will have offset this dramatically by profiting on the put option.
    - The advice here would be to hold onto the shares and sell the put option. As we are always trading Blue Chip stocks they will go back up in time and we will be able to continue to generate income through selling call options.

Scenario 3

At expiry of the option the share price is trading @ 38.00

Outcome

- Both your call option and your put option will expire worthless
- You will have generated income from the net premium received from the options transaction
- You will have made money on your shares
- You will have lowered your average cost on the shares from 37.50 to 36.75

What are the risks?

As mentioned earlier, this particular strategy looks to mitigate risk. The risks are:

- Opportunity risk
    - This comes about if the share price rallies strongly – the investor will only participate in the upside up to the strike of the sold call + premium received.
    - The investor will still profit – however this will be capped
- Downside risk.
    - As pointed out earlier there is an element of downside risk. The majority of this however is covered by the put option.
    - In this example there is an overall risk of 75cents or $750

Can I use this strategy in a self managed super fund (SMSF)?

Absolutely YES! We highly recommend investors look at using this strategy with in a SMSF as the free protection this strategy provides is a very attractive aspect for investors to consider.

Obviously superannuation is something we all need to think about – the Collar is a great way to build as well as protect your fund.

Can I use the 'Collar Spread' on every stock in the ASX/200?

No, the stock must have an options market over it and not every stock does. As a rule of thumb the investor will be able to write covered calls on most of the ASX/50 and all of the ASX/20 blue chip stocks.

Can I use this strategy in a Margin Loan?

Yes! Many of our clients use this particular strategy in a Margin Loan as the written call not only generates income but also helps offset the interest component as well.

Having our protective leg in place also ensures the investor is exposed only to a limited amount of risk.

Danny Moss is a Private Client Adviser with Vertical Financial Solutions and can be contacted on 02 9126 8944 or email d.moss@verticalfinancialsolutions.com.

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DERIVATIVES TRADING TERMINOLOGY

By Glen Van Ooran

American Option - An option that can be exercised before the expiry date.

Arbitrage - Arbitrage is a practice by which a position is taken in one market whilst an opposing position is simultaneously taken in another related market in order to take advantage of a pricing mismatch.

Backwardation - Backwardation occurs when the forward delivery contract can be bought at a discount to the current spot price of the underlying market.

Buying to Close - Buying a short position back in the market in order to close a trade.

Contango - A contango occurs when a forward delivery contract is currently trading at higher prices than the spot price of the same contract.

Contract for Difference - An over the counter derivative product that trades via a bid ask spread quoted by the issuer. As the product does not trade on an official exchange, the product is not regulated nor novated by an exchange.

Cost of Carry - The cost of holding the underlying asset whilst options or futures contracts are sold against that asset.

Credit Spread - A position made up of two or more legs that is placed for a net credit.

Debit Spread - A position made up of two or more legs that is placed for a net debit.

Derivative - A tradeable instrument that's value is derived from an underlying market.

Early Exercise - Early exercise refers to an American option or warrant being exercised before the expiry date occurs.

European Option - An option that can only be exercised upon the expiry date.

Exchange Traded - A product or market that trades on an official exchange.

Exercise - When the taker of an option or warrant pays the writer the exercise price amount required to convert the derivatives product into the underlying market instead.

Exercise Price - The price at which the transfer of the underlying asset takes place at once an option or warrant is exercised by the taker.

Extrinsic Value - Extrinsic value is the sum of time value plus the implied volatility reflected in the current price of a derivatives contract.

Fair Value - The current theoretical value of a derivative calculated using a model containing five known variables, and one fixed input.

Forward Price - The price of the underlying market reflected at the expiry date of a futures contract.

Hedge - A strategy implemented as a form of insurance to limit the risk associated with an underlying market, or existing trade.

Historical Volatility - The volatility of an underlying market calculated over a historical period of time.

Strike Price - The strike price is related to options and warrant trading only, and is otherwise known as the 'exercise price' of the tradeable contract. The exercise price is fixed during the life of the contract and represents the price at which the underlying market is to change hands at, once the option or warrant is exercised.

Implied Volatility - The current level of volatility factored into the price of an option, warrant or futures contract.

Initial Margin - The minimum amount required to open a position in either a futures contract or a short options position.

Intrinsic Value - The difference between an option's exercise price and the current value of the underlying market.

Leverage - The ability to control a larger amount of exposure to a market using a smaller amount of capital.

Liquidity - Often gauged by the width of the bid ask spread and the number of contracts which can be traded.

Long - The process of buying to open a position.

Long- Dated - A contract that still has plenty of time to go before expiry.

Margin Call - When the value of an account falls below the required level to keep a position, or number of positions, open.

Market Maker - A person or institution who operates a "bid ask" spread in a derivatives market, on behalf of an exchange.

Night Market - An electronic after hours market designed to allow positions to be traded when the general market is closed.

Novation - The guarantee that an exchange provides whereby the exchange will guarantor the delivery of a contract in the event of either party to a contract defaulting on their obligations.

Open Interest - The number of current open option positions within a contract as per the previous market close.

Open Outcry - The manual method of trading used on the trading floor of an official exchange.

Option Taker - The person who pays the premium to the option taker in order to obligate the writer of the option if required.

Option Writer - A person who sells to open an option position in the options market.

Overnight Risk - The risk associated with the fact that the Australian market is closed whilst the US market is trading. This often causes opening gaps to occur in the Australian market, which can play havoc with stop loss positions.

Over The Counter - A tailor made contract between two parties that does not trade on an official exchange.

Physical - The cash or underlying market.

Pit Session - A market that trades via an open outcry system rather than electronically on an exchange.

Premium - The amount paid to the writer of an option to compensate that person for their acceptance of risk from the option taker.

Profit Stop - A strategy instigated to close a profitable trade should a risk to the position become apparent.

Risk Free Rate of Return - The return that can be achieved by taking zero risk, in other words the return which can be achieved on a capital guaranteed investment for a designated period of time.

Rolling Down - Closing and moving an option position to the next strike price down in the same expiry month.

Rolling Up - Closing and moving an option position to the next strike price up in the same expiry month.

Rolling Out - Closing and moving an option position to the next expiry date out, whilst keeping the strike price the same.

Selling to Close - Selling a long position back in the market in order to close a trade.

Short - The process of selling to open a position.

Short- Dated - The closest contract to expiry.

Slippage - The difference between the price you intended to enter or exit a trade, versus the actual price in which your transaction was filled.

Spot - The current market price of either the cash market or the short-term futures contract.

Spread - The price difference between the bid and the ask in the same market, or the price difference between two derivatives contracts in the same market.

Stop Loss - An order placed to close a losing trade in order to keep losses to a controlled amount.

Time Value - The current time value factored into the premium of a derivatives contract, which reflects the time to expiry of the contract.

Variation Margin - The day-to-day movements of an underlying market is used to monitor open positions in a futures trade, or a written option position. The variation margin is the extra collateral required by an exchange, in order to keep a position open once a trade has moved against either party to a trade.

Volatility - An average of daily closes compared with the average trading range of an underlying market.

Volume - The amount of turnover what has occurred in the market over a given period of time.

Zero Sum - Zero sum applies to the futures market and simply means, that for every dollar lost by one party to a trade, that dollar is made by the opposing party to the trade.

Glen Van Ooran can be contacted at glen.vanooran@lifestyletrader.com.au.

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This bulletin is produced by the: Australian Investors Association

PO Box 7439
Gold Coast MC Qld 9726
Tel: 1300 555 061 Fax: 07 5538 8376
Email: aia@investors.asn.au
Web: www.investors.asn.au

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