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# **Capital Protection for Safety and Profit**

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# Robert Shiller's CAPE Ratio

YTD

1Y

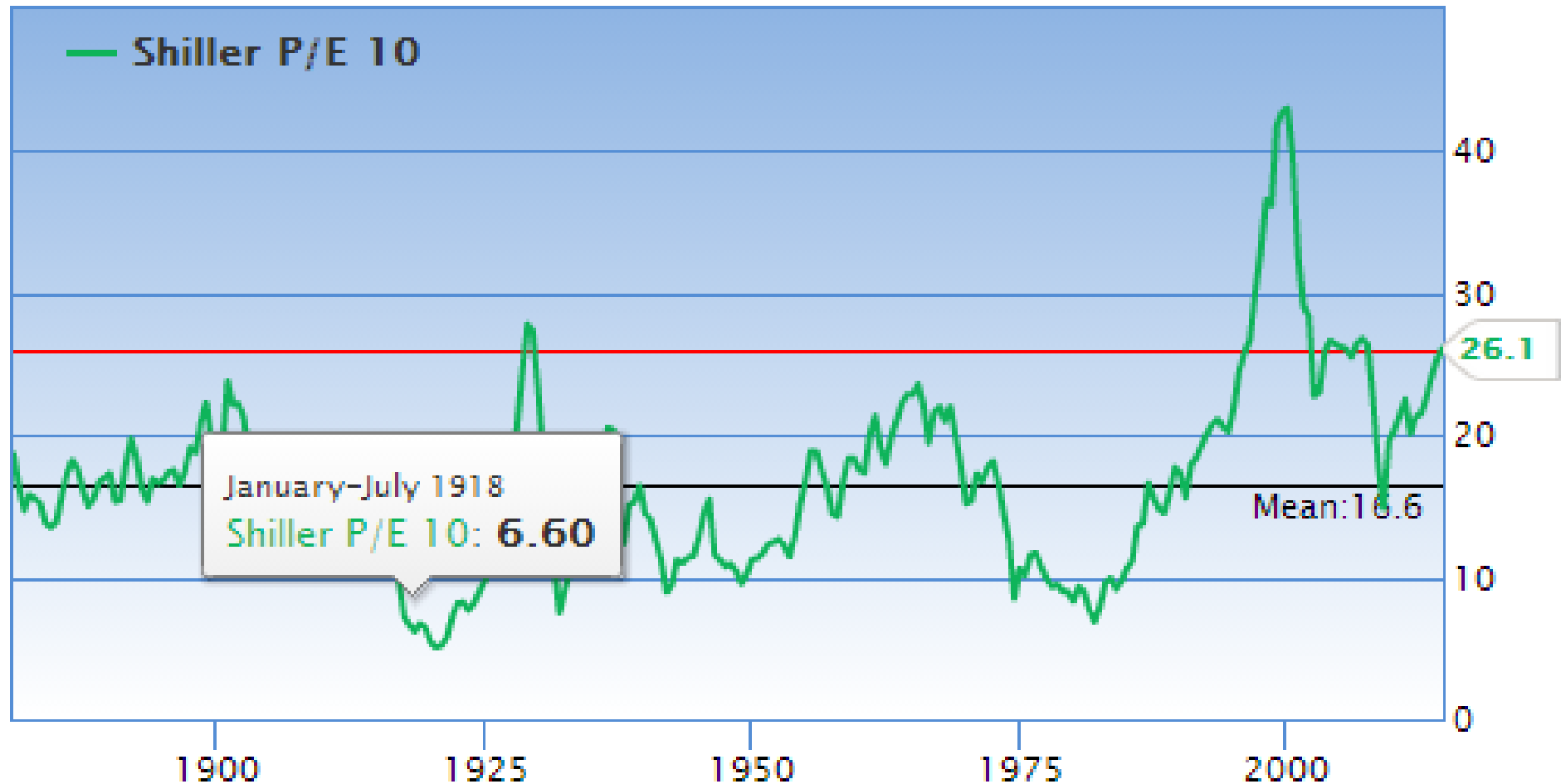
3Y

5Y

10Y

All

Embed



# CAPE Ratio

Robert Shiller's cyclically-adjusted price-earnings (CAPE) ratio

- CAPE is calculated by taking the S&P 500 and dividing it by the average of 10 years worth of earnings.
- Expensive when above 16x.
- Currently, 26.1x, which has some people concerned that the stock market is over valued.
- Indeed, when we were at these levels at 2008, we soon saw sharp drops in the stock market.

I'm not suggesting you dump stocks and hide in cash because the CAPE is at 26. Rather, buy less, be cautious, and expect lower returns for years to come.



# Robert Shiller's CAPE Ratio

YTD

1Y

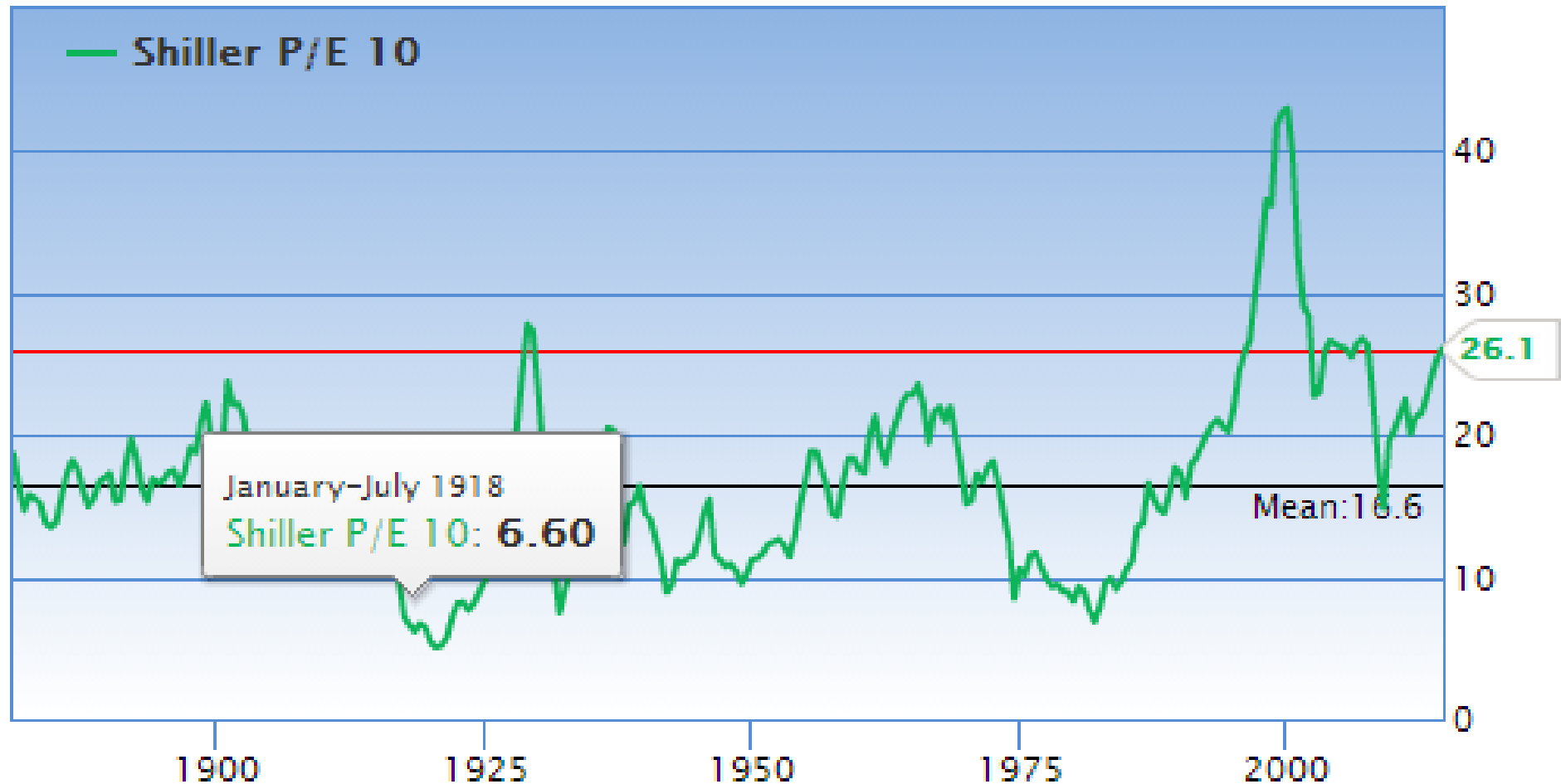
3Y

5Y

10Y

**All**

Embed



# S&P 500



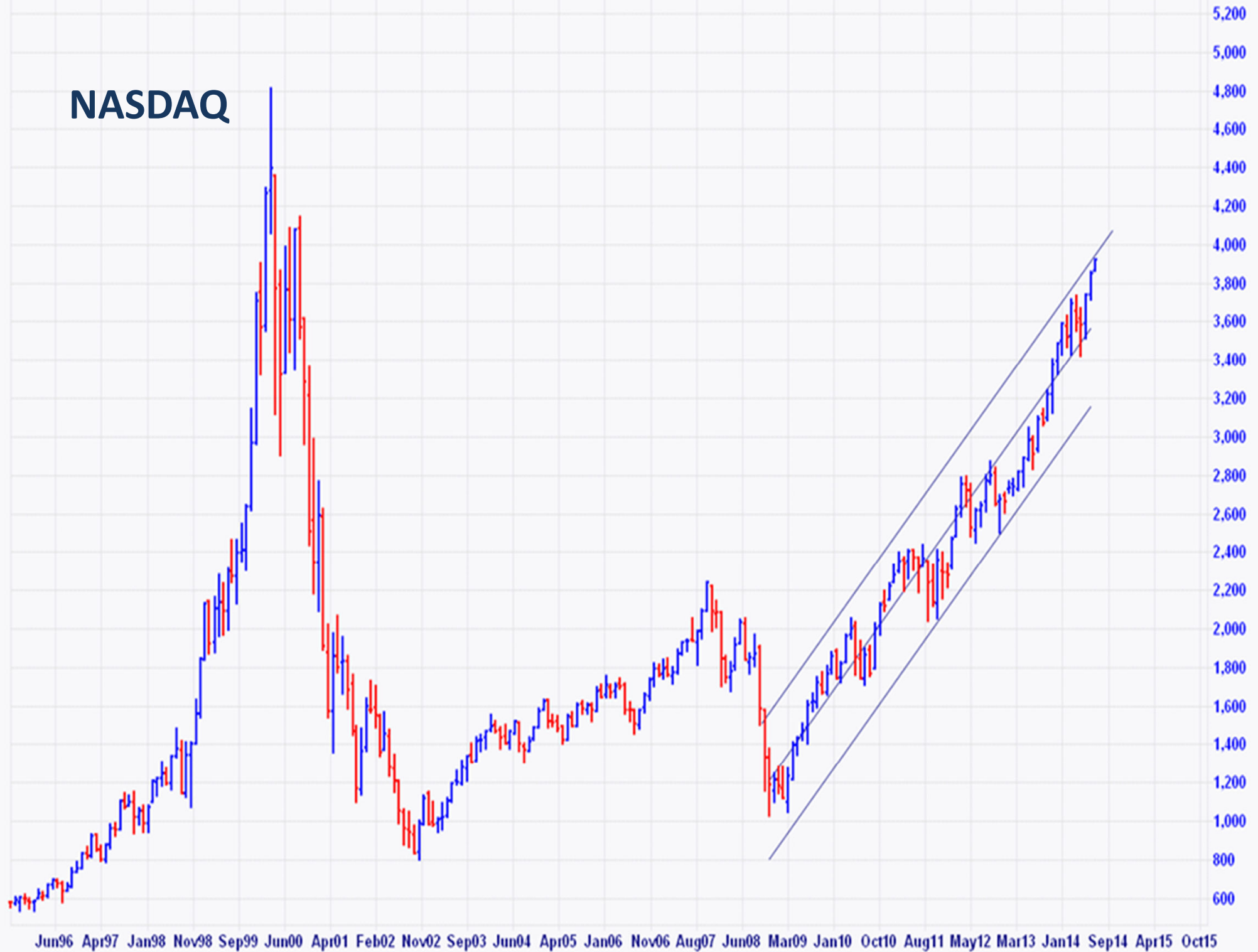


# DOW





# NASDAQ



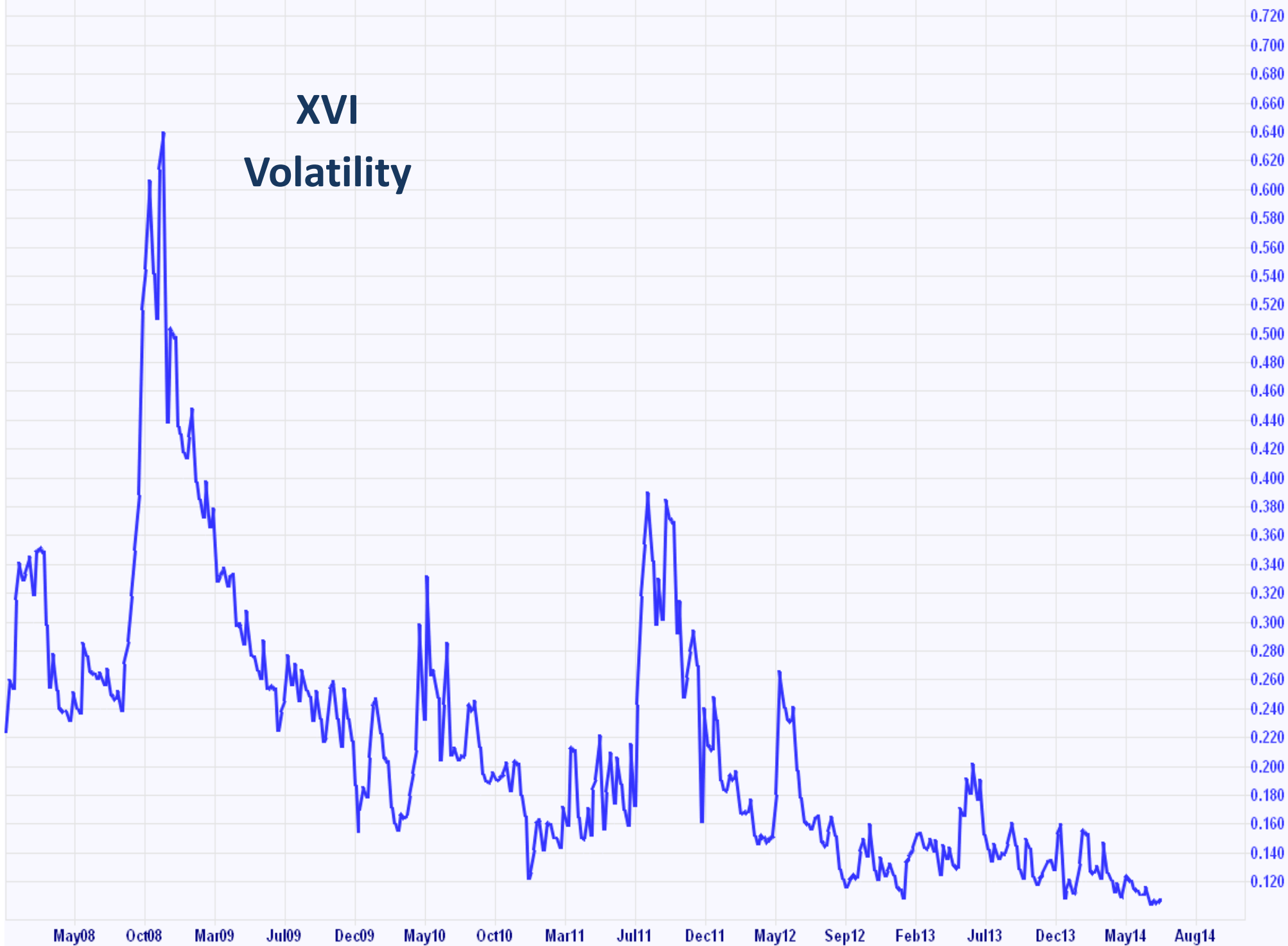
# Shanghai



# XJO 200



# XVI Volatility



## Two Approaches to investing

There are several different styles of trading which will more often than not categorise a investor into one of the two below.

**Hedger** - A person whose primary motivation is not seeking profits, but instead to reduce the risk of adverse price movements in a security. a hedge consists of taking an offsetting position in a related security.

Investors use this strategy when they are unsure of what the market will do. A perfect hedge reduces your risk to nothing (except for the cost of the hedge).

**Speculator** - A person seeking large profits in return for large risks by trying to anticipate price movements, in the hope of making, large gains. Speculators are typically sophisticated; risk-taking investors with expertise in the market(s) in which they are trading and will usually use highly leveraged investments such as futures and options.

## What is hedging

- To understand hedging is to think of it as insurance.
- When you hedge, you insuring against a negative event.
- This doesn't prevent a negative event from occurring, but if it does happen and you're properly hedged, the impact of the event is reduced.
- Hedging occurs almost everywhere, and we see it everyday.
- For example, if you buy house insurance, you are hedging yourself against fires, break-ins or other unforeseen disasters.

## The Downside

Every hedge has a cost, so before you decide to hedge consider the following.

- The benefits received, justify the expense.
- Hedging isn't to make money but to protect from losses.
- The cost of the hedge - cannot be avoided.
- The price you pay to avoid uncertainty.



## Conclusion

- Risk is an essential yet precarious element of investing, regardless of what kind of investor one aims to be.
- Having a basic knowledge of hedging strategies will lead to better awareness of how investors and companies work to protect themselves.
- Whether or not you decide to start practicing the intricate uses of derivatives, by learning about how hedging works, will help advance your understanding of the market.
- Which will always help you be a better investor.

## Why Hedge a Portfolio

Hedging your exposure does not have to be rocket science, but it does require diligent attention to the market and your portfolio. Investors who feel the market is overvalued have two options: move into other asset classes (cash, bonds), or hedge their market exposure.

When an investor owns shares they are exposed to two main types of risks:

- Company Risk – the risk that the specific company will underperform, and
- Market risk- the risk that the whole market will underperform.

An investor may have several reasons not to sell the underlying shares at the current point of time.

- The investor may believe that in the longer term the share price will rise, and
- Selling shares may have adverse taxation implications.
- Increased transaction fees.

BNB



# RIO



# XJO 200



# MQG



# CBA





# Identifying a hedge (technical's)

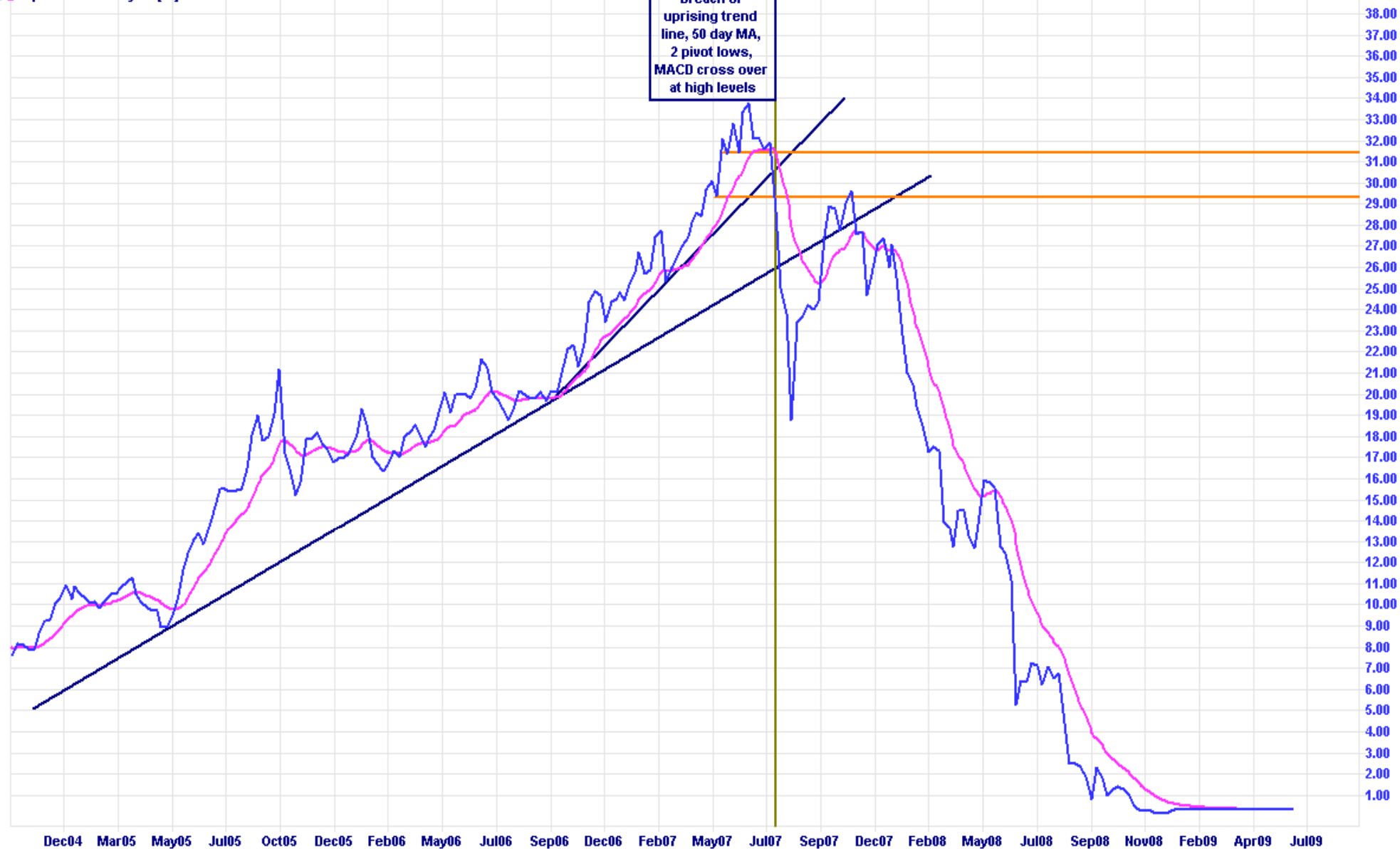
So how do you know when to hedge your portfolio or shareholding, for those of you who use technical analysis the answer is a little more clear, to demonstrate I have used some basic tools and a longer term weekly chart to demonstrate.

Some examples are;

- Breach of an uprising trend line.
- 50 day exponential moving average
- Breach of pivot lows
- MACD moving average cross over

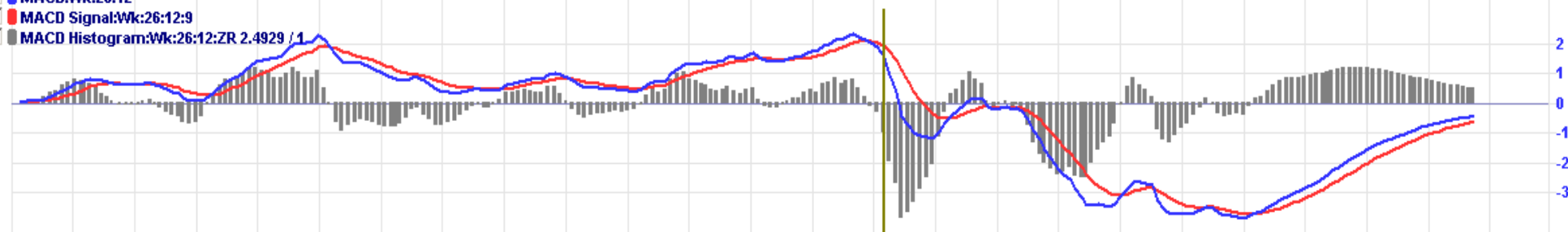
✓ **BABCOCK & BROWN LTD [ BNB ]:Wk:w** 18Jun2009 19:00  
✓ **Exponential MA:Dy:50:w**

Breach of  
uprising trend  
line, 50 day MA,  
2 pivot lows,  
MACD cross over  
at high levels



0.325  
0.3282

✓ **MACD:Wk:26:12**  
✓ **MACD Signal:Wk:26:12:9**  
✓ **MACD Histogram:Wk:26:12:ZR 2.4929 / 1**

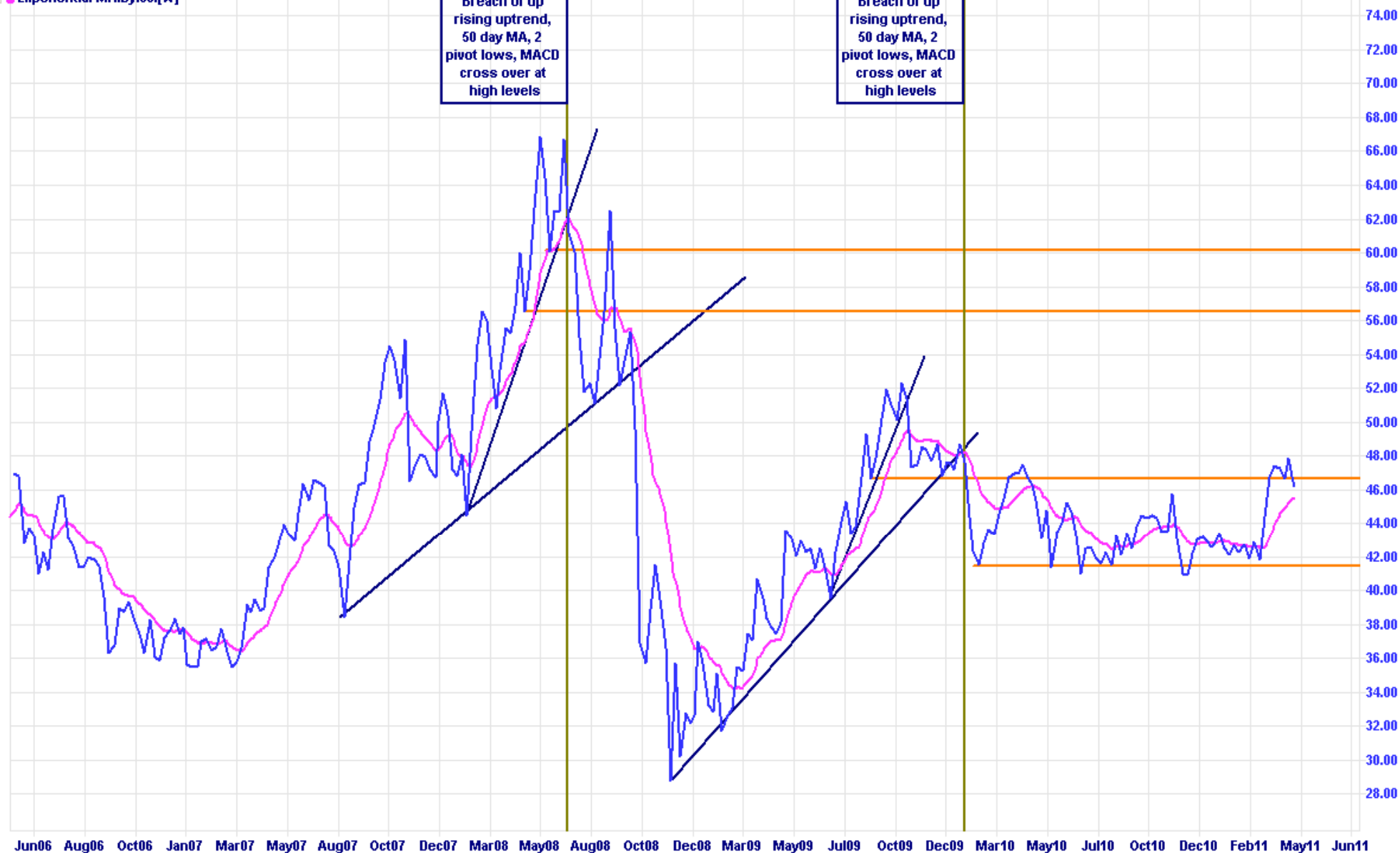


-0.4182  
-0.5991  
0.1809

WOODSIDE PETROLEUM [ WPL ]:Wk:[w] 03May2011 11:00 Sydney : Hourly Delayed > 20mins  
Exponential MA:Dy:50:[w]

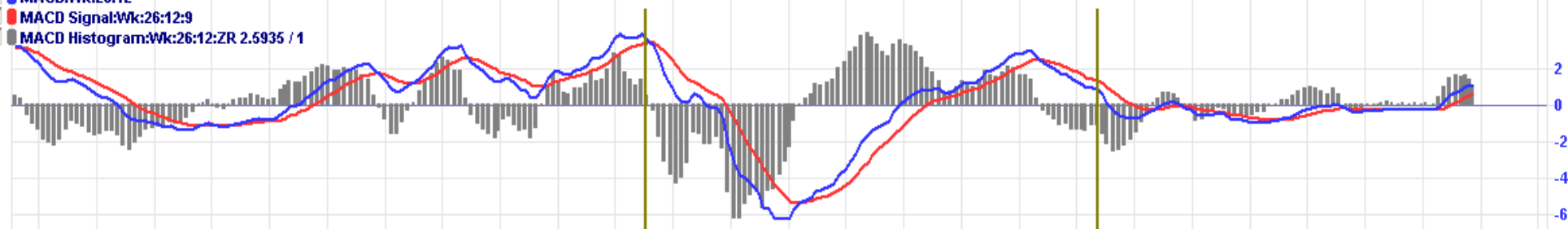
Breach of up  
rising uptrend,  
50 day MA, 2  
pivot lows, MACD  
cross over at  
high levels

Breach of up  
rising uptrend,  
50 day MA, 2  
pivot lows, MACD  
cross over at  
high levels



46.22  
45.5012

MACD:Wk:26:12  
MACD Signal:Wk:26:12:9  
MACD Histogram:Wk:26:12:ZR 2.5935 / 1



1.0372  
0.6399  
0.3972

## What is an ETO (Exchange Traded option)

- An option is a contract to buy or sell a financial product.
- For equity options, the underlying instrument is a share or (ETF).
  - It establishes a specific price, called the strike price, at which the contract may be exercised, or acted on.
  - And it has an expiration date. When an option expires, it no longer has value and no longer exists.
- Options come in two varieties,
  - calls and puts,
  - you can buy or sell either type. - based on what you want to achieve as an options investor.

|             | Buy (Holder)  | Sell (Writer)      |
|-------------|---------------|--------------------|
| Call Option | Right to Buy  | Obligation to Sell |
| Put Option  | Right to Sell | Obligation to Buy  |

## Benefits of trading ETO's

Exchange traded options (ETOs) can be used in a variety of ways to profit from a rise or fall in prices.

- Hedging, Protect the value of individual shares or a portfolio
- Income Generation through writing options
- Undertake to buy shares for less than their current price
- Lock in a buying price
- Get exposure to shares for limited risk

## Components of ETO's

There are five key components to the pricing of options

- The underlying security
- The strike or exercise price
- Contract size (shares per contract)
- Expiry date
- Premium

Option values are not pre-set and the option premium is determined by market forces.

## In, at, or out-of-the-money

### *In, at, or out-of-the-money options*

The relationship between an option's strike price and the price at which the underlying is trading is referred to as being i-t-m, a-t-m and o-t-m.

|             | Strike price <<br>share price | Strike price =<br>share price | Strike price ><br>share price |
|-------------|-------------------------------|-------------------------------|-------------------------------|
| Call option | In-the-money                  | At-the-money                  | Out-of-the-money              |
| Put option  | Out-of-the-money              | At-the-money                  | In-the-money                  |



## Why use put options to protect a shareholding

- The put option guarantees the sale price of the underlying shares for the life of the option.
- Without using put options the investor's choice are:
  - Watch the value of the shares fall
  - sell them. (Obviously if the investor has a strongly bearish view regarding the longer term view of the shares, the appropriate course of action may be to sell the shares.)
- Return to cash and you forgo potential capital appreciation.
- Put option Taker, can benefit from a rise in the share price. Maximum risk is the option premium paid.
- Should the share price fall, the investor sell's to close the put option at a profit, partially offsetting the fall in the underlying shares
- This strategy is one of the few taken option strategies where the best result is in fact for the underlying share price to rise significantly.

## Index options to protect a portfolio

There are several ways to protect a share portfolio against market risk using index options. One of these is to buy an index put option for protection against a fall in the whole market.

### Assumptions:

- It is June,
- The XJO ASX200 index is at 4700 points.
- Diversified portfolio worth \$470,000,
- The investor believes that there may be a downturn in the market over the next three months.

As an alternative to selling shares directly, the investor needs to calculate how many options are required to hedge the position as well as which exercise price (index level) and which expiry date.

# Index options to protect a portfolio

The hedge ratio, or the number of options needed to hedge the value of the investor's portfolio, is as calculated as follows:

$$\text{Number of Index Options} = \frac{\text{Value of Portfolio}}{(\text{exercise price of option} \times \text{index multiplier})}$$

$$\text{Number of Index options} = \frac{\$470,000}{(4700 \times \$10.00)} = \frac{\$470,000}{\$47,000}$$

$$\text{Number of Index options} = 10$$

## Index options to protect a portfolio

The September 4700 put gives the investor the right, but not the obligation, to sell the underlying index at a level of 4700 at expiry at September.

Assume that at expiry in September, the index has fallen by 10% to 4230 points and, as a result, the September 4700 put is in-the-money.

|  |  |
|--|--|
| <b>XJO put series</b>                            | <b>September 4700</b>                              |
| <b>Purchase price</b>                            | <b>90 Points</b>                                   |
| <b>Number of contracts</b>                       | <b>10</b>  |
| <b>Total Outlay (not including Brokerage)</b>    | <b>\$9000 (90 x \$10 x 10)</b>                     |
| <b>Effective Portfolio Coverage</b>              | <b>\$470,000 (4700 x \$10 x 10)</b>                |
| <b>Option Breakeven (index level)</b>            | <b>4610 (4700 – 90)</b>                            |
| <b>Portfolio value – index @ 4230 (10% fall)</b> | <b>\$423,000 (loss of \$47,000)</b>                |
| <b>Value of 4700 index put with index @ 4230</b> | <b>\$47,000 (10 x 470 x \$10)</b>                  |
| <b>Maximum total loss (excluding Brokerage)</b>  | <b>\$9,000 (cost of purchasing put protection)</b> |

## Index options to protect a portfolio Summary

- Therefore the net position is a loss of \$9,000.
- The loss of \$47,000 in the value of the shares has been offset by the profit on the option trade.
- The overall net loss of \$9,000 is the premium value, or the cost of the option (insurance)

In reality it is unlikely that the portfolio will track the index exactly and neither the put option exactly offset the fall in portfolio value. However, for a well-diversified portfolio of stocks similar to those that make up the index, the strategy can still be quite effective.

## *Share put options to protect a shareholding*

Example; *Buying a protective put*

Assume an investor holds 5000 XYZ shares, currently trading at \$4.00 the investor is Concerned that the Share Price may fall over the next three months, and decides to buy a put option to protect the shareholding.

The following three September expiry put options are available.

| Option Strike Price               | <i>In, at, or out-of-the-money options</i> |
|-----------------------------------|--|
| XYZ September \$3.75 put @ \$0.09 | out-of the money put option                |
| XYZ September \$4.00 put @ \$0.19 | at-the-money put option                    |
| XYZ September \$4.25 put @ \$0.33 | in-the-money put option                    |

The standard contract size for a share option is = 100 Shares per contract

Number of put Options required = No. of shares / (No of shares per contract)

Number of put options = 5000 / 100 = 50

Number of share put options = 50



# Share put options to protect a shareholding

Assume that at expiry the share price has fallen by 25% to \$3 The net position for the protective strategy for the three options

|                 |        | XYZ shares | Shares + 375 Put | Shares +400 Put | Shares + 425 Put |
|-----------------|--------|------------|------------------|-----------------|------------------|
| Initial Value   | Shares | \$4        | \$4              | \$4             | \$4              |
|                 | Option | -          | \$0.09           | \$0.19          | \$0.33           |
|                 | Net    | \$4        | \$4.09           | \$4.19          | \$4.33           |
| Value at expiry | Shares | \$3        | \$3              | \$3             | \$3              |
|                 | Option | -          | \$0.75           | \$1             | \$1.25           |
|                 | Net    | \$3        | \$3.75           | \$4             | \$4.25           |
| Profit/Loss     | Net    | -\$1       | -\$0.34          | -0.19           | -\$0.08          |

➤ Therefore the OTM option (375 put) has the lowest premium, but provides the least protection of the three options.

➤ The ITM(425 put) offers the most protection in that a 25% fall in the share price is reduced to a 2% net loss, but the option has the highest premium.

➤ The ATM (400 put) may offer the best balance between risks and potential rewards of the strategy.



# Share put options to protect a shareholding

## So which option to buy?

The choice of exercise price involves a trade-off between cost of cover and the amount of cover, with the put with the highest premium providing the most protection.

## Expiry Month?

- The choice of expiry month is a balance the cost of the option premium against the expected timeframe of the fall in share price.
- The longer the time of the option bought, the more time the underlying stock has to fall, or from the investors view the greater period of protection.
- The more time the investor buys, the more expensive the option will be.
- As a guiding principle is to select an expiry date that matches the timeframe of the expected move.

## Added Bonus

### *What to do with the profits from your put protection*

- Earn a small amount of interest
- Spend it
- You could use the cash to acquire additional shares and receive additional yield

This will have the added benefit if the shares price rise in the next cycle, you have the potential for capital growth and increased yield by increasing your overall portfolio.

You then look to hedge again when you believe markets may have another pullback.

## Just Remember

### *Words from WARREN BUFFET*

There are two rules of investing.

”Rule #1 - Don't lose money.

Rule #2 - Never forget Rule #1

No one looks after your finances like you

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