



ASX

AUSTRALIAN SECURITIES EXCHANGE

# ASX Equity CFDs: Protect your position

Being leveraged instruments, ASX Listed CFDs™ offer significant upside potential but also expose you to downside risk. When trading ASX Equity CFDs, it is possible to develop strategies to protect your downside risk without limiting your upside potential.

The use of exchange traded options (ETOs) in conjunction with ASX Listed CFDs can deliver a protection strategy that offers more flexibility and may cost less than the guaranteed stop loss orders currently available for non-ASX Listed CFDs.

## ASX Listed CFD/ETO Protection Strategy

The strategy to adopt will vary depending upon whether you have bought or sold ASX Listed CFDs.

| ASX LISTED CFD POSITION                | ETO POSITION  |
|--|---|
| Long – You have bought ASX Listed CFDs | Buy a put option in the underlying share to protect your "long" CFD position;   |
| Short – You have sold ASX Listed CFDs  | Buy a call option in the underlying share to protect your "short" CFD position. |

## Strategy benefits

This simple combination of ASX Listed CFDs and ETOs has a number of benefits over guaranteed stop losses as a tool for managing and protecting your downside risk:

- **Time and Flexibility:** Both guaranteed stop losses and ASX Listed CFD/ETO protection strategies will protect you if the market price for the ASX Listed CFD moves beyond your down-side price limits.

Importantly, the ASX Listed CFD/ETO protection strategy gives you the time and flexibility to respond to any unexpected price deterioration.

Most guaranteed stop loss products automatically close out your position. With the ASX Listed CFD/ETO protection strategy the trade remains open, without exposing you to further down-side risk. This gives you the time and flexibility to review your trading strategy before responding.

- **Cost effectiveness:** An ASX Listed CFD/ETO protection strategy may provide more cost effective protection than a comparable guaranteed stop loss product.

This will vary, however, depending upon the characteristics of the option contracts used (such as time to maturity and strike price). In addition, if you trade out of an ASX Listed CFD position without needing to use the protection of the ETO, the options, unless expired, will retain some value that can be realised by selling them back into the market.

## Issues to consider when trading ETOs

1. **Choosing the Strike (protection level):** Choose an option with the strike at the level you want to limit the risk on the trade. For instance, if you are "long" an ASX Listed CFD at \$10 and want to protect the position from a move below \$9, you would choose an option (put) with a strike of \$9.

Conversely, if you were "short" an ASX Listed CFD at \$10 and wanted to protect the position from a move above \$11, you would choose an option (call) with a strike of \$11.

2. **Choosing the Term (expiry of the ETO):** The option expiry month needs to reflect how long you plan to hold the ASX Listed CFD position. If the option has one week until expiry, but you expect to hold the trade for more than a week, the next expiry month may be a better choice.

3. **Determining the number of option contracts required:** Each ASX option contract represents 1,000 shares of the underlying stock. Therefore a 5,000 long ASX Equity CFD position would require only 5 equity put options for protection. A 2,000 short ASX Equity CFD position would require only 2 equity call options for protection.

This fixed contract size means that if you wish to protect ASX Listed CFD positions which are not in multiples of 1,000 you must choose between being over or under-hedged.

- If under hedged – the maximum risk on the position is not limited, although the rate at which the position loses money during an adverse price move is reduced.
- If over hedged – the cost of the hedge is increased.

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## Examples of a combined ASX Listed CFD and ETO position

### 1. Protecting a long ASX Listed CFD position in Westfield Group\*

Sara has bought 2,000 ASX Westfield CFDs at 1750 (\$17.50).

- Sara decides to protect her "long" ASX Listed CFD position from a move below \$16.50 by buying put options.
- She expects to hold the ASX Westfield CFD position for up to two weeks, so she selects a put option with a \$16.50 strike that expires after this time.
- Each option contract represents 1,000 shares and, therefore, Sara buys 2 put option contracts to protect her 2,000 ASX Westfield CFD position.

Sara knows that once she has the put options in place the downside risk on her 2,000 ASX Westfield CFDs is limited should the ASX Westfield CFDs move below the put option strike price of \$16.50. However, the potential profit on the trade remains unlimited.

Once Sara decides to close her long ASX Westfield CFD position, she has two options in relation to her ETO holdings:

- If her ETOs are "in the money", (i.e., the shares are trading below the strike price) she can either:
  - Sell the ETOs on ASX or
  - "Exercise" the ETOs, i.e., sell the physical shares, (provided she already owns them) at the strike price.In both instances, the profit will have provided her with the required protection.
- If her ETOs are "out of the money" she can sell them on ASX with the proceeds reducing the cost of protection.

## Further information

On ASX Listed CFDs, go to [www.asx.com.au/cfd](http://www.asx.com.au/cfd)

On ASX ETOs, go to [www.asx.com.au/options](http://www.asx.com.au/options)

### 2. Protecting a short ASX Listed CFD position in News Corp\*

Joe has sold 1,000 ASX News Corp CFDs at 1700 (\$17.00).

- Joe decides to protect his "short" ASX Listed CFD position from a move above \$18.00 by buying a call option.
- Joe expects to hold the ASX News Corp CFD position for up to a month and so he selects a call option with a \$18.00 strike that expires in two months' time.
- Each option contract represents 1,000 shares and, therefore, Joe buys only 1 call option contract to protect his 1,000 ASX News Corp CFD position.

Joe knows that once he has the call option in place the upside risk on his 1,000 ASX News Corp CFDs is limited should the ASX News Corp CFDs move above the call option strike price of \$18.00. He has not limited the position's potential profit from any downwards movement in the price.

Once Joe decides to close his long ASX News Corp CFD position, he has two options in relation to his ETO holdings:

- If his ETOs are "in the money", (i.e., the physical shares are trading above the strike price) he can either:
  - Sell the ETOs on ASX or
  - "Exercise" the ETOs and buy the physical shares at the strike price.In both instances, the profit will have provided the required protection.
- If his ETOs are "out of the money" he can sell them on ASX with the proceeds reducing the cost of protection.

Importantly, the difference between using a guaranteed stop loss to protect the CFD position and using the ASX Listed CFD/ETO protection strategy is that ETO strategy will not be automatically closed out. Instead, the position remains open giving the holder time and the flexibility to review the trading strategy before responding.

\* Brokerage has been ignored in this example.

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