



ASX

AUSTRALIAN SECURITIES EXCHANGE

# ASX Index CFDs: Protect your position

Being leveraged instruments, ASX Listed CFDs™ offer significant upside potential but also expose you to downside risk. When trading ASX Index 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 index to protect your “long” CFD position;   |
| Short – You have sold ASX Listed CFDs  | Buy a call option in the underlying index to protect your “short” CFD position. |

## Strategy benefits

This simple combination of ASX Index 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 Index 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 Index 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 S&P/ASX 200 CFD at 5,800 and want to protect the position from a move below 5,600, you would choose an option (put) with a strike of 5,600.

Conversely, if you were “short” an ASX S&P/ASX 200 CFD at 5,800 and wanted to protect the position from a move above 6,000, you would choose an option (call) with a strike of 6,000.

**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 Index CFD represents 1 unit of the underlying currency. For example, 1 S&P/ASX 200 CFD has a value of A\$1 per point. The equivalent S&P/ASX 200 ETO has a value of A\$10 per point. Therefore a 10 long ASX S&P/ASX 200 CFD position would require only 1 S&P/ASX 200 ETO put option for protection. A 20 short ASX Equity CFD position would require only 2 S&P/ASX 200 ETO call options for protection.

This fixed contract size of ETOs means that if you wish to protect ASX Index CFD positions which are not in multiples of 10 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 Index CFD and ETO position

### 1. Protecting a long ASX S&P/ASX 200 CFD position

Sara has bought 10 ASX S&P/ASX 200 CFDs at 5,800 (A\$5,800). \*

- Sara decides to protect her "long" ASX Listed CFD position from a move below 5,600 by buying put options.
- She expects to hold the ASX S&P/ASX 200 CFD position for up to two weeks, so she selects a put option with a 5,600 strike that expires after this time.
- Each option contract represents the equivalent of 10 times the CFD and, therefore, Sara buys 1 put option contracts to protect her 10 ASX S&P/ASX 200 CFD position.

Sara knows that once she has the put options in place the downside risk on her 10 ASX S&P/ASX 200 CFDs is limited should the ASX S&P/ASX 200 CFD price move below the put option strike price of 5,600. However, the potential profit on the trade remains unlimited.

Once Sara decides to close her long ASX S&P/ASX 200 CFD position, she has two alternatives in relation to her ETO holdings:

- If her ETOs are "in the money", (i.e., the S&P/ASX 200 Index is trading below the strike price) she can either:
  - Sell the ETOs on the ASX ETO market; or
  - "Exercise" the ETOs, i.e., cash settle the ETO and receive the difference between the market close and 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)

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### 2. Protecting a short ASX S&P/ASX 200 CFD position

Joe has sold 10 ASX S&P/ASX 200 CFDs at 5,800 (A\$5,800). \*

- Joe decides to protect his "short" ASX Listed CFD position from a move above 6,000 by buying a call option.
- Joe expects to hold the ASX S&P/ASX 200 CFD position for up to a month and so he selects a call option with a 6,000 strike that expires in two months time.
- Each option contract represents the equivalent of 10 times the CFD, therefore, Joe buys only 1 call option contract to protect his 10 ASX S&P/ASX 200 CFD position.

Joe knows that once he has the call option in place the S&P/ASX 200 Index is upside risk on his 10 ASX S&P/ASX 200 CFDs is limited should the ASX Listed CFDs move above the call option strike price of 6,000. He has not limited the position's potential profit from any downwards movement in the price.

Once Joe decides to close his long ASX S&P/ASX 200 CFD position, he has two alternatives in relation to his ETO holdings:

- If his ETOs are "in the money", (i.e. the S&P/ASX 200 Index is trading above the strike price) he can either:
  - Sell the ETOs on the ASX ETO market; or
  - "Exercise" the ETOs, i.e. cash settle the ETO and receive the difference between the market close and the strike price.

In both instances, the profit will have provided him with 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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