

The Sharemarket & Beyond

Solutions for Volatile Times
– Trading & Protection

November 2008

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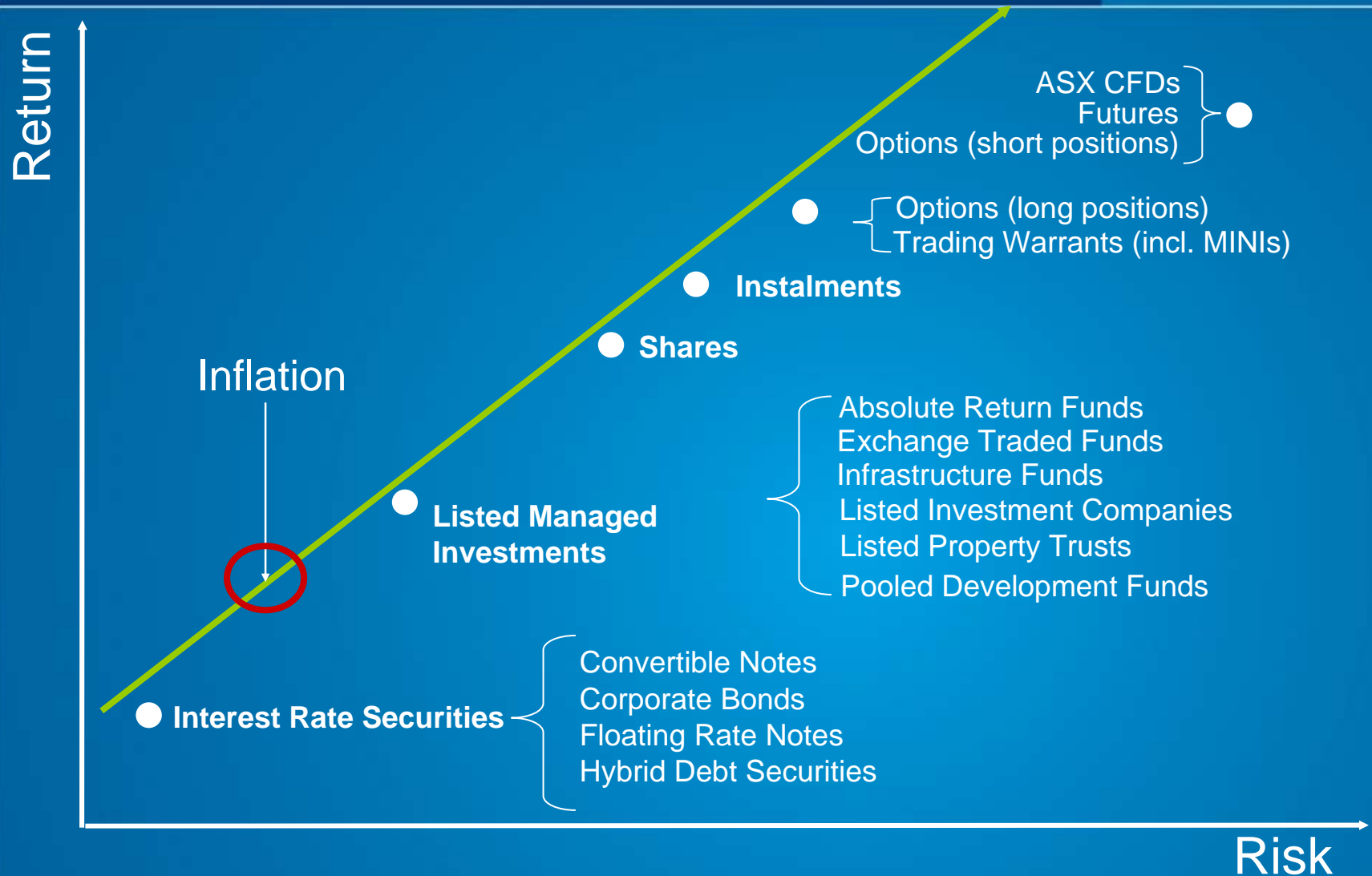
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This presentation is not to be taken as taxation advice. Instead it should be used as a precursor to further discussions with a qualified taxation consultant.

Agenda

- ASX product suite risk/return profile
- Protection Strategies using Put Options/Warrants & CFDs
- Leverage
 - Margin lending v instalments v CFDs
- Volatility Strategies
 - CFD long/short
 - Options straddle and strangles
- Stock Repair
- Next Steps

The ASX Product Suite



Protection Strategies

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Protection Strategies

- 2 alternatives
 - Put Options
 - Allows profits to keep running
 - Can be costly
 - ASX CFDs
 - Earn income whilst protection is in place
 - Doesn't allow profits to keep running
 - Need lots of cash to maintain position if shares rise

Options as “insurance” for shares

- Insurance is commonly used for protection of assets such as cars, home and contents, income and personal health
- Similarly, we can take positions in derivative markets that hedge our exposure in markets for underlying assets

When looking at Australian equities:

- Underlying market – **ASX**
- Underlying asset – “Blue chip” shares
- Derivative market – **Exchange Traded Options Market**
- Hedging instrument – most commonly a **Put Option**

Put Options

- An option to **sell** the underlying CBA Trading at \$41.00
- **Example CBA December \$41.00 PUT @ 200 cents.**

Gives the taker the right to sell CBA for \$41.00 any time up until, and including, the expiry date in December.

For this right, the taker pays a premium (200 cents) to the writer. The writer must buy 1000 CBA at \$41.00 if called upon (exercised) to do so by the taker.

Why use put options for protection?

Advantages

- Lock in a sale price for your shares (sleep at night!)
- Margin lending – avoid margin calls
- Retain unlimited profit potential
- Retain the benefits of stock ownership (dividends, voting rights etc)
- Allows time to decide on a course of action
- Can help to keep emotions in check

Disadvantages

- Protection comes at a cost

Comparing options for cover

The following are hypothetical put option values for stock XYZ, which is currently trading at \$30.00:

Put Strike/ Month	Dec '08	Mar '09	Jun '09
\$30.00	\$1.01	\$1.84	\$2.74
\$29.00	\$0.59	\$1.41	\$2.27
\$28.00	\$0.31	\$1.00	\$1.85
\$27.00	\$0.14	\$0.71	\$1.45
\$26.00	\$0.05	\$0.45	\$1.11

Just like any insurance premium, the cost of protection directly corresponds with the length and level of cover required.

The gap between the current stock price, and any option of a lower strike price taken for protection, can be considered as the “excess” to be borne by the investor should a fall occur.

Determining the cost of protection?

Any factor that increases the possibility of loss for the seller of the option will make the option more expensive - as sellers need compensation commensurate with the risk they take on.

- **The higher the agreed selling price (strike price), the more expensive the put option**
- **The longer the time to expiry, the more expensive the option**
- **The greater the volatility of the underlying stock, the more expensive the option**
- Other influences on an options value include interest rates, dividends and market expectations

ASX CFDs

- A CFD (Contract for Difference) is an agreement between a buyer and a seller to exchange the difference in value of a contract between when the contract is opened and when it is closed.

Traded @ \$30.00		
Buyer		
Seller		

ASX CFD Trading Strategies

Hedging a physical position



Jo

Holds 1,000 CBA Shares

Sells 1,000 ASX CBA CFDs (CU)

Open

Sells CU @ \$50.00

Value = \$50,000

IM Paid = \$3,700

*Cashflows

Receive CI – OIC = \$7.54

- Pays Div Cashflow
- Pays FCC

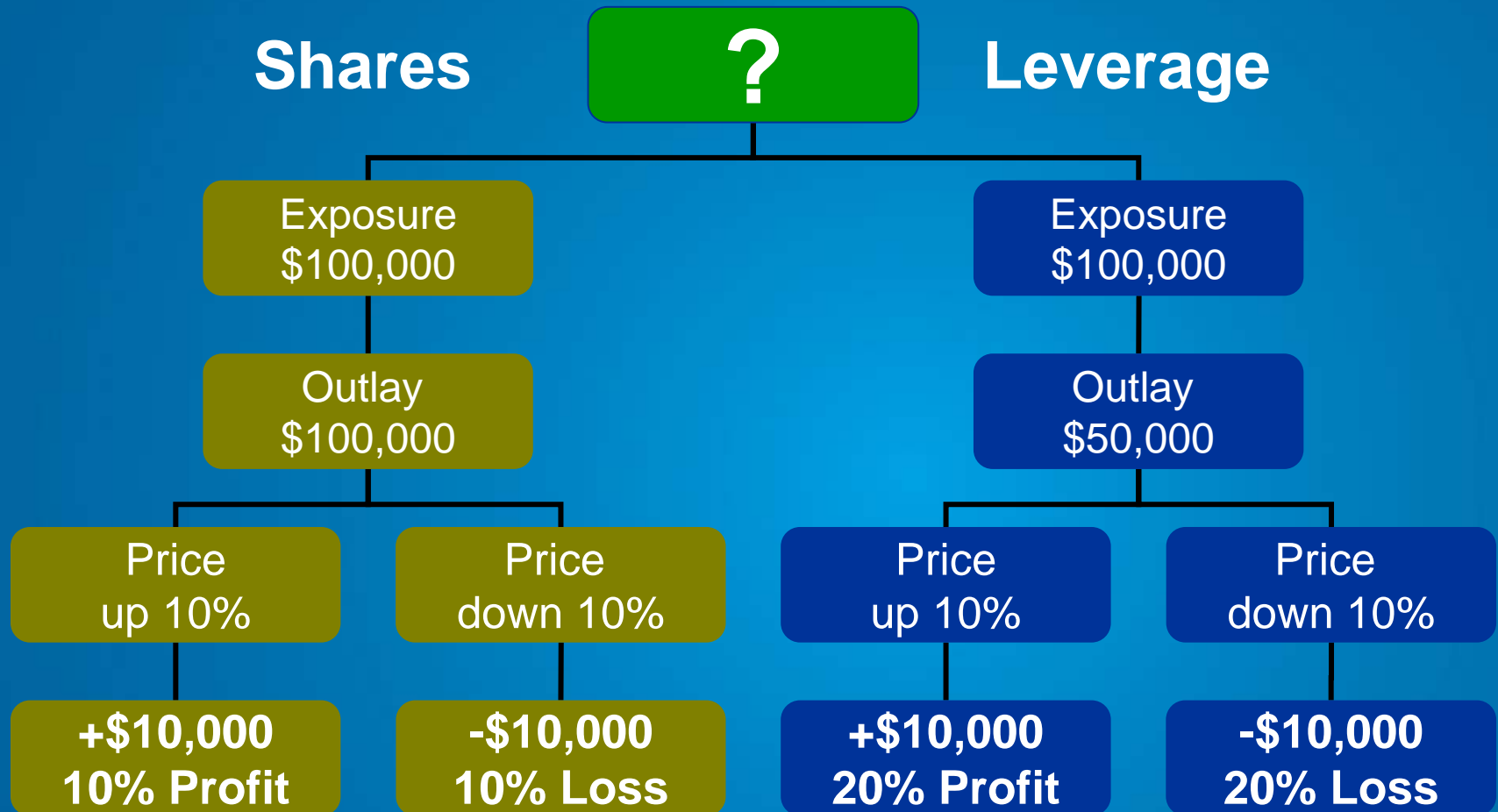
Price	Shares	ASX CFD	Net P&L*
\$70.00	\$20.00	-\$20.00	\$0
\$60.00	\$10.00	-\$10.00	\$0
\$50.00	\$0	\$0	\$0

Leverage

Margin Lending v Instalments v CFDs

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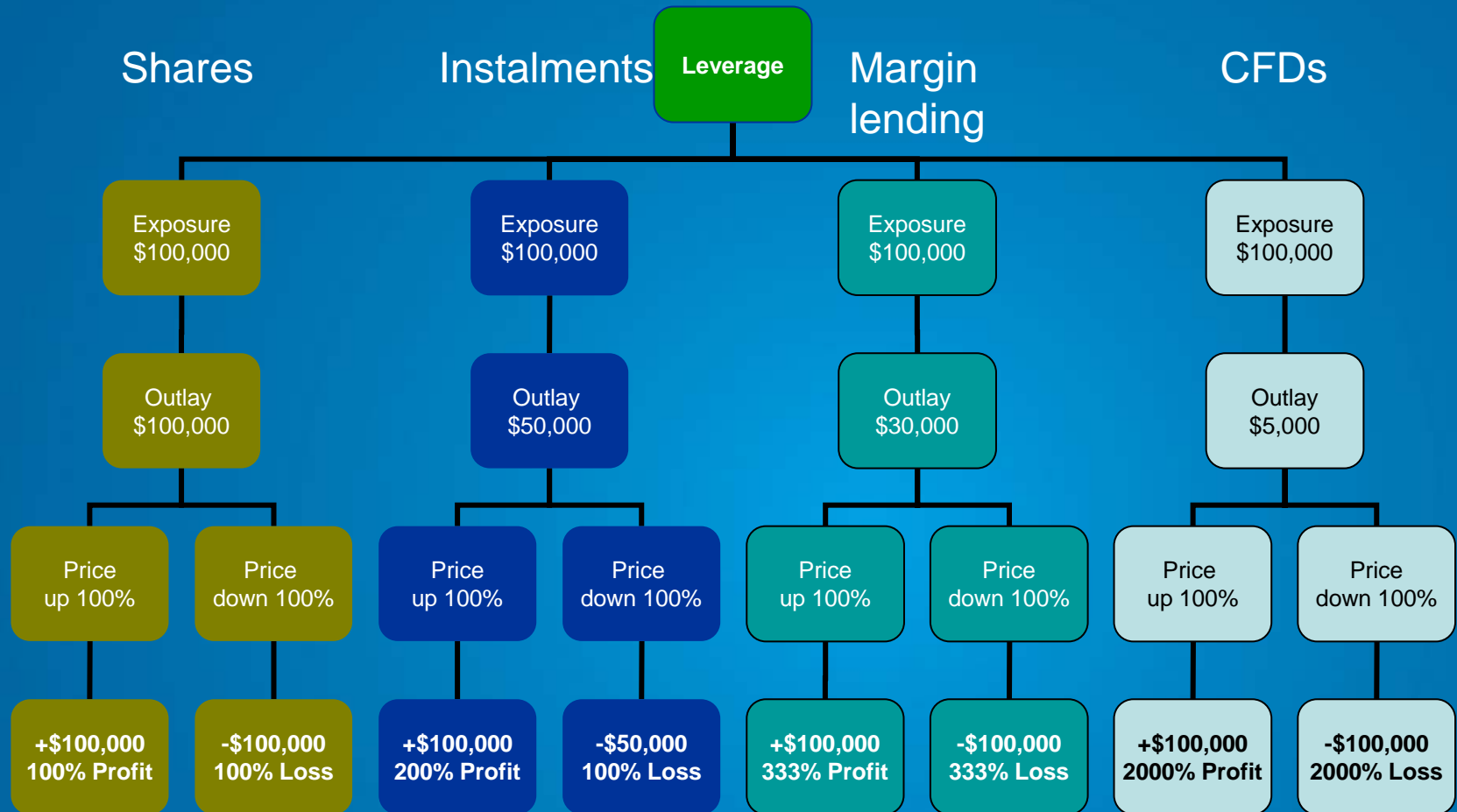
What is Leverage?



Leverage Summary

	Margin Lending	Instalments	ASX CFDs
Large no. of securities avail.	✓	✗	✗
No margin calls	✗	✓	✗
Extra leverage	Sometimes	✗	✓
SMSF eligible	✗	✓	Hedging

Leverage Comparison



Volatility Strategies

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Volatility Strategies

- 2 alternatives
 - ASX CFDs
 - Trade small moves in the market for large returns
 - Can trade long or short
 - Can be costly if you are wrong
 - ETOs
 - Straddles or Strangles
 - Make money regardless of market direction
 - Need the market to move

ASX CFD Trading Example

Day Trade - Equities



Harry

Buys 1,000 ASX Newcrest CFDs (NG) for a day trade

Open

Buys NG @ \$22.00
Value = \$22,000
IM Rate = \$9.76
IM Paid = \$9,760

Close

Sells BJ @ \$23.00
IM Returned

Profit of $\$1.00 \times 1,000 = \1000
10% of IM used to support position

Options – The basics

	CALL	PUT
B U Y E R	The right to buy	The right to sell
S E L L E R	The obligation to sell	The obligation to buy

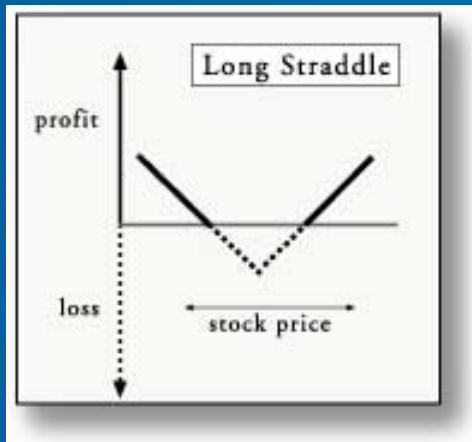
Long straddle / strangle



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<u>Nature of strategy</u> <i>High risk/ high reward</i>	<u>Risk</u> <i>Loss of premium</i>	<u>Reward</u> <i>Limited by the size of move in the stock</i>
<u>Ideal price environment</u> <i>Bull or Bear Market.</i>	<u>Profit potential if successful</u> <i>100% to 300% + p.a.</i>	<u>Strategy characteristics</u> <i>Requires skill in stock selection and timing</i>

Long Straddle



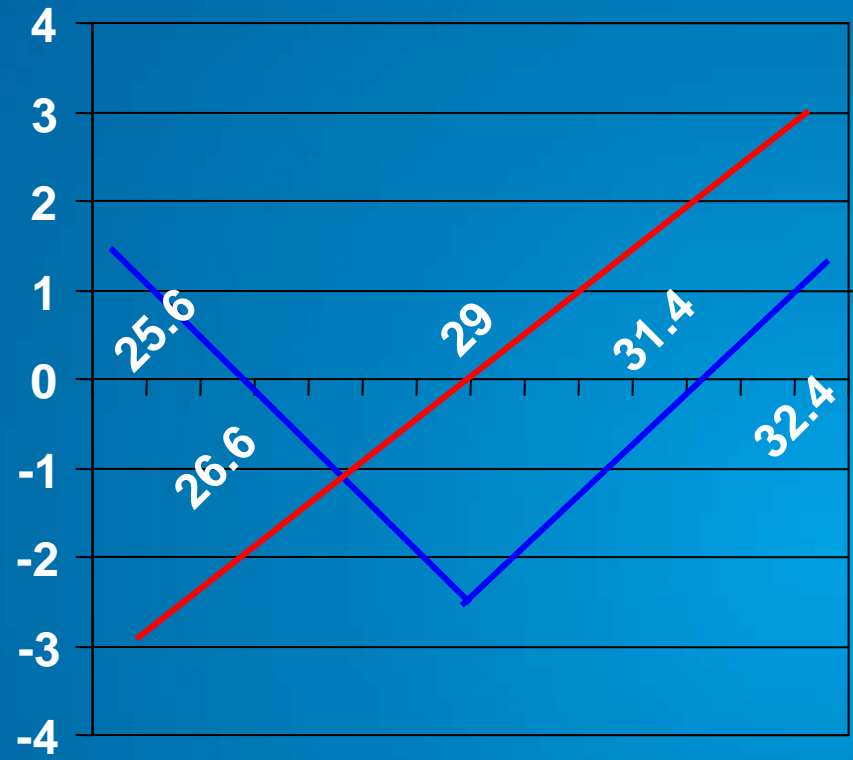
- Looking for a big move away from the strike price
- Buy same strike, same expiry, call and puts
- Need to commit to straddles for them to pay off



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Long Straddle – WOW @ \$29.00

Profit / Loss per share



Buy DEC \$29 Call at \$1.30 = \$1,300 dr
Buy DEC \$29 Put at \$1.10 = \$1,100 dr
Buy straddle for \$2.40 \$2,400 dr

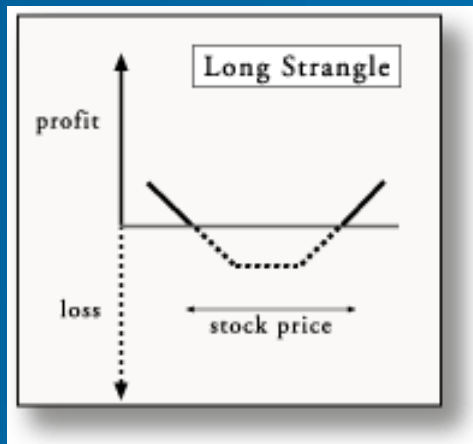
- Long stock
- Long Straddle (long call and put)

Stock value at expiry

Long Strangle



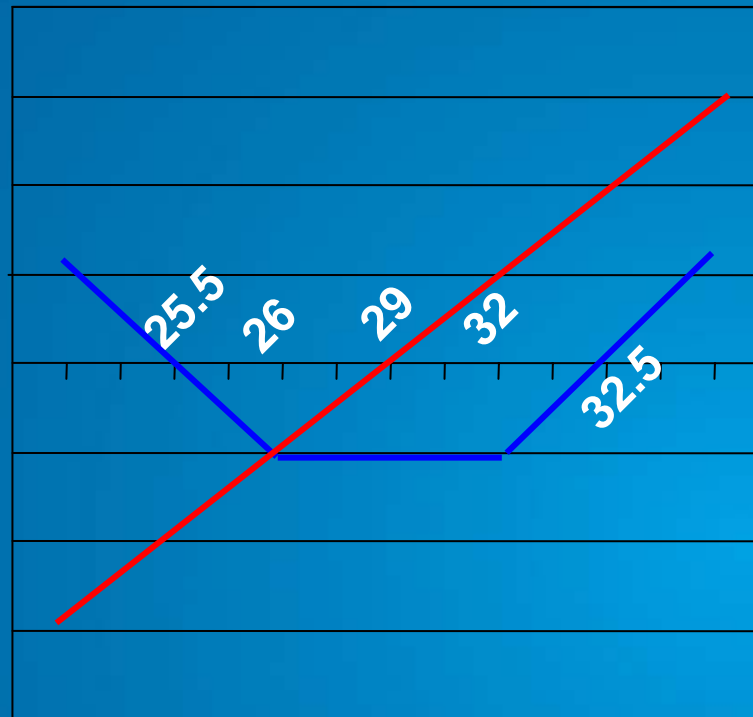
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- Buy out-of-the-money calls & puts; same expiry
- Cheaper than straddle
- Requires a larger move than straddle to break-even
- Max. loss, between exercise prices

Long Strangle – WOW @ \$29.00

Profit / Loss per share



Buy DEC 32 call at \$0.25 = \$250 dr
Buy DEC 26 put at \$0.25 = \$250 dr

Buy strangle for \$0.50 500 dr

- Long stock
- Long Straddle

Stock value at expiry

Stock Repair

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Stock Repair



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- You have a stock position that has declined in value 15 to 20%
- You believe that the stock price decline has ended, and you have a target price several points higher than the current level
- You think that “averaging down” is a poor money management technique
- You don’t want to increase the risk of the position, you just want to breakeven and move on

Stock Repair

XYZ trades at \$30 on November 2008

Cost basis \$40 on 1,000 shares

February \$30 calls @ \$3.00

February \$35 calls @ \$1.50

CONSIDER OPTION REPAIR OVERLAY

Buy (1) February \$30 call @ \$3.00 = 3.00

Sell (2) February \$35 call @ \$1.50 = (3.00)

NET COST \$0.00

Stock Repair

Stock Price @ Exp.	Loss on Stock	Call Values Feb		Net Position (P&L)
		\$30.00	\$35.00	
\$30.00	(\$10.00)	-	-	(\$12.00)
\$31.00	(\$9.00)	+\$1.00	-	(\$8.00)
\$33.00	(\$7.00)	+\$3.00	-	(\$4.00)
\$35.00	(\$5.00)	+\$5.00	-	(\$0.00)

How to get started

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Next Steps – www.asx.com.au

- Online Education
- Paper Trade (Sharemarket Game)
- Read a book (ASX Way)
- Find a broker

Start small