AUSTRALIAN INVESTORS' ASSOCIATION Special Interest Groups

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derivatives

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Welcome To Derivatives

By Neil A. Costa

Welcome to the January 2003 edition of the Australian Investors' Association (AIA) newsletter on derivatives. I hope you enjoyed a relaxing Christmas and spent some high quality time with your family.

Traders and investors are now looking ahead with great anticipation, wondering what this year has in store for them. Nevertheless, we are hearing conflicting forecasts for the year ahead.

Will it be a bull market year for major world stock markets? It would be foolish to dismiss this out of hand, as the last few 10-year cycles have been strong bull years. Or will the market resume its downward path?

According to W. D. Gann's Master Time Factor the fourth year of the decade (2004) is likely to be a bear market year and the fifth year (2005) a bull market year. Mr. Gann was so confident that the fifth year of the decade would be a bull market he named it the 'Year of Ascension'. He died in 1955 and every fifth year of the decade since then has been a bull market year.

Only time will tell. Of course, only a fool acts on a forecast instead of acting on market reality as it unfolds.

In this edition of *Derivatives*, we have three excellent articles – 'Trading the Australian Dollar Using Margin Foreign Exchange' by Geoff Howie, 'Writing Call Options Using Instalment Warrants as Collateral' by Laurence Laveau and 'Western Mining Resources (WMR) – Negative View, An Idea' by Ian Keys, Hartleys.

Please do not hesitate to submit an article for publication. The article can discuss how you use derivatives, or be about a trade you have made – successful or otherwise. You may simply wish to ask a question, the answer to which will assist you and many other readers. If you would like to contribute, please send any articles or questions to me – neil@marketmasters.com.au or at www.marketmasters.com.au .

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Writing Call Options Using Instalment Warrants as Collateral

By Laurence Laveau

This month's learning curve focuses on an increasingly popular strategy – writing call options using instalment warrants as collateral. As will be explained, writing call options against instalment holdings is a good way to generate income in a flat market or alternatively provide some protection in a falling market.

What does writing a call option mean?

As you are probably aware, writing a call option (or a warrant for that matter) gives the buyer the right, but not the obligation, to buy the underlying stock from you at a given price (the exercise price or strike of the option/warrant). In return for this right, the buyer pays the seller (you) a premium.

The seller of the option is obliged to lodge funds or securities with the Options Clearing House (OCH) in order to cover adverse market movements. This is known as covering a margin obligation. Certain instalment warrants can now be lodged as collateral. These warrants must be regular leverage warrants and they must be broker-sponsored. (You can call 1800 8255 74 to find out the eligibility of particular series).

As is often the case, the benefits of this strategy are best explained by way of an example:

Strategy - You believe that the ANZ share price is likely to remain flat for the next month or so but wish to retain exposure to any potential upside in the share price and be entitled to the upcoming dividend.

The Trade(s) - On 22/10/02, ANZIGA you buy 1,000 ANZIGA warrants at $9.98 with ANZ shares at $17.94. You then lodge the instalment with the OCH and write (sell) one Nov $19.00 call option, receiving a premium of $135.00 or $0.135 per share covered by each contract (i.e. 1000 shares). Net outlay for the total investment is therefore $9,845 (i.e. instalment warrant price – option premium received).

Scenario 1 - Share Price Remains Flat.

If ANZ remains at $17.94 until the option expiry on 28/11/02, the option will expire worthless resulting in a profit for the seller of $0.135. The instalment warrant is worth $9.93, 5 cents less than the purchase price, reflecting the fact that interest has accrued over the period. This interest may also be tax deductible.

In addition to the premium of $135 from the sale of the option, ANZIGA goes ex at 46-cents (fully franked dividend) over the period. When grossed up for franking credits**, this totals $0.66. So for 1,000 ANZIGA you will receive $657.14 in dividends and franking credits.

All up, if the shares remain at $17.94, the profit is $742.14, which equates to an annualised return of 117% (see below).

Profit Analysis	28-Nov-02
Assumed Final Share Price	$17.94
Instalment Price	$9.93
Total Instalment Value	$9,930.00
Value of Position	
Sold Call Option	$0.00
Instalment Warrant	$9,930.00
Gross Dividends	$657.14
Total Value	$10,587.14
Net Outlay	-$9,845.00
Profit	$742.14
Return	7.5%
Annualised Return	117.0%

Scenario 2 - Share Price Increases:

Writing the $19.00 call option for $0.135 allows the instalment warrant holder to participate in upside up to $19.135 on ANZ (i.e. strike of the call option plus call option premium) an increase of 6.66% from $17.94. Any share price upside beyond this level will go to the buyer of the option. The option contract should be closed out above $19.00, by buying back the option. More importantly, ANZIGA which has a delta of 98% will increase by $1.17 (i.e. ($19.135-$17.94) x 98%)) an increase of 11.7%. The warrant is therefore worth $11.10, even after interest accrual of 5 cents. The holder will also be entitled to the dividend and franking credits**.

Profit Analysis	28-Nov-02
Assumed Final Share Price	$19.135
Instalment Price	$11.10
Total Instalment Value	$11,100.00
Value of Position at ETO expiry	
Sold Call Option	-$135.00

Instalment Warrant	$11,100.00
Gross Dividends	$657.14
Total Value	$11,622.14
Net Outlay	-$9,845.00
Profit	$1,777.14
Return	18.1%
Annualised Return	486.4%

Scenario 3 - Share Price Falls:

In the event of the share price falling, the holder of the instalment has protection equal to the value of the written call. In this case $0.135, equates 1.4% of the purchase price of ANZIGA.

If you want to find out more about this strategy, call SG on 1800 8255 74. We will be able to tell you which of our warrants may be lodged as collateral with the OCH and answer questions you may have. Let us know if you are purchasing SG instalment warrants with the express intention of writing a call option, as we will happily provide you with a market in the option, too. SG Warrants – your one-stop investment shop!

**The 45-day holding period rule requires that resident taxpayers hold shares (or instalments over these shares) for at least 45 days to be eligible to receive franking benefits from dividends paid on shares. The franking credit is denied if the resident has eliminated 70% or more of the ownership risk through other financial transactions during that period. For further information please refer to the Australian Taxation Office website www.taxreform.ato.gov.au

Laurence Laveau is Marketing Manager, Equity Derivatives at SG Australia Ltd (SGAL). She is an ASX-accredited derivatives adviser Level 1 and 2.

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Trading the Australian Dollar Using Margin Foreign Exchange

By Geoff Howie

Like equity investors, futures traders have a choice between getting full service or ‘execution only’ service from brokerage companies. Execution-only service attracts discounted fees, as little to no assistance is required from the broker. On the other hand, full service brokering involves a great deal of assistance from brokers, thereby attracting higher fees. Execution-only brokerage is fairly self explanatory and many reviews have been published on the topic as of late, so I thought it would be useful to outline a few of the aspects of full service brokering.

While this list is not exhaustive, support services that come under the banner of ‘full service’ include:

- General Market Conditions – A full service broker supplies market conditions (bid / offer depth, highs and lows of the market) so when a client calls to get a feel for where the market is or has been, then they are requesting advice.

- Technical and Fundamental Research and Analysis – Full service brokers will provide a number of different market reports each day. Some will email up to 40 different charts each day, which include contract specifications and news summaries.

- Internet Trading Facilities – Over the last few years, futures markets around the world have replaced open outcry floor trading sessions with electronic trading facilities. Browser based on-line trading systems for private traders and investors have subsequently been introduced and most full service brokers offer this service to clients alongside traditional telephone, fax or email-based dealing.

- Seminars/Education Programs – As mentioned in the previous feature 'Trading with Structure', before the commencement of futures trading, most brokers will recommend that traders undergo some form of a training process. Trader education is perhaps one of the most important aspects of full service brokering.
  For example, Man Financial provides a full range of seminars each year covering economic interpretations of markets, all major areas of technical analysis, the building of trading plans as well as an introduction to futures. Full service brokers will also arrange speakers within the futures industry to present seminars that fall under the speakers established niche. Supplementary texts and written material should also be available for traders who live in remote areas.

- 24-hour Service – Man offer a 24-hour broking service on 1800 hotlines. This allows clients to capture trading opportunities in offshore markets such as Chicago, London and New York, as well as for Sydney Futures Exchange (SFE) contracts traded outside of normal business hours.

- State of the Art Website Facilities - Traders using full service brokers should be able to access session prices, charts as well as their account and trade details online.

- Account Management - Full service brokers should aspire to always being aware of the trader's position as well as the first notice day and expiry/delivery dates of any commodity or currency positions that the trader might hold.

This checklist should provide some insight into the level of assistance that a trader can expect from a full service broker. In time, as traders become more experienced, the execution-only style of broker generally becomes more appealing.
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QUESTION: I am thinking of trading the Australian All Ordinaries Share Price Index. How much money do I need to open an account, and why?

Trading one position in the SFE Share Price Index 200 (SPI 200) requires a trader to open an account with $10,000. This is all to do with the risk involved in trading futures. The Share Price Index provides exposure to an equity portfolio with an

underlying value of approximately AUD$75,000 (i.e. 3000 x AUD$25). With every one-point movement a trader is subject to a profit or loss of AUD$25 before brokerage. The SPI 200 currently moves an average of 35 points in a single trading session. Therefore, on average, one trading lot could represent a profit or loss of AUD$875 (AUD$25 x 1 contract x 35 points) per contract before brokerage.

Once a trade is opened the Clearing House requires enough funds in the traders account to cover initial and variation margins that involve the lodging or receiving of daily settlement margins. The initial margin, sometimes called the deposit, acts as a security for each futures contract opened and is refunded when the futures position is closed out, providing the trader meets all payments. The initial margin is currently AUD$2,250 per contract on the SPI 200. The initial margin represents a percentage of the underlying value of the contract and is carefully calculated to cover the maximum expected movement in the market from one day to the next. Variation margins occur on a daily basis and reflect the actual profit or loss incurred on an open futures position.

It is important for clients to provide sufficient funds for both initial margins and variation margins. Experience has shown that $10,000 provides an optimal amount to commence trading one SPI 200 contract in case the trader enters the market while their trading system is experiencing a drawdown.

Geoff Howie is a futures and foreign exchange advisor at Man Financial. He can be contacted via email on ghowie@manfinancial.com.au. Futures Trading involves the potential for both profits and losses

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WESTERN MINING RESOURCES (WMR) - NEGATIVE VIEW, AN IDEA

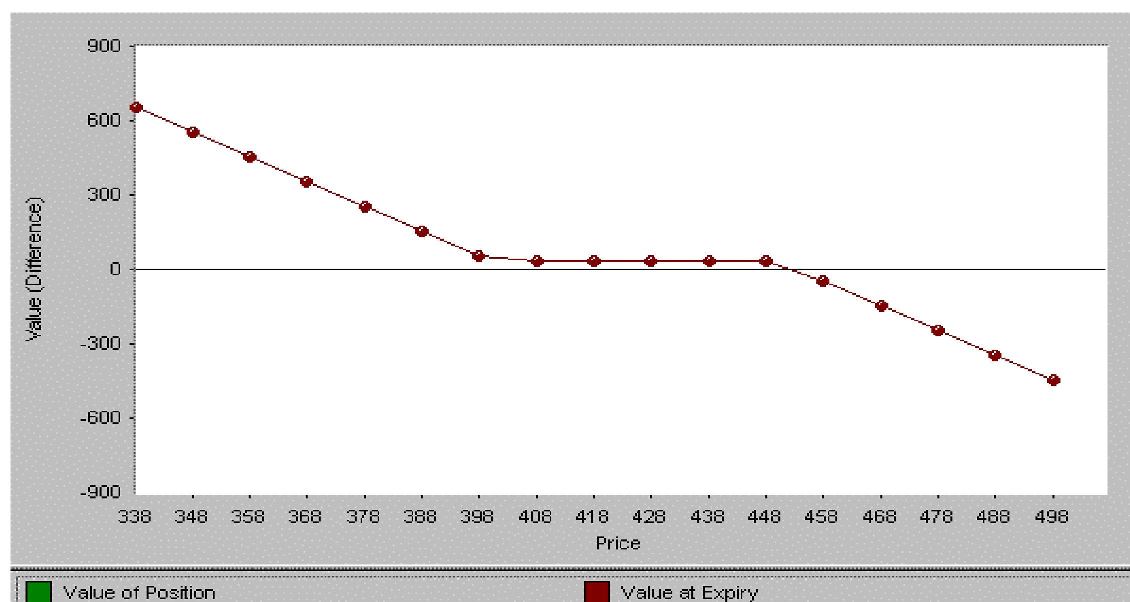
By Ian Keys

(Position traded 19/12/02 – WMR was trading at $4.22)

I am negative on WMR at the moment as base metals are just off their highs, and WMR is very close to fully priced. On the Merrill Lynch research, they expected that on the break-up of WMC, Alumina Ltd would be trading at around $5.10 - $5.60 per share and WMR would trade at $2.50 - $3 per share. Their best case valuation at the top of the metals price cycle would have WMR trading at $4.18, today it closed at $4.22, having recently rising from $3.50 on the first day of listing. On this basis, even if a takeover came in tomorrow, I think that the best case for the stock would be $4.50 - $5.

Rio Tinto has been known to have an interest in diversifying further, and they are very keen on the low cost Nickel assets, and especially the world class Olympic Dam Mine (Copper, Gold, and Uranium) which are owned by WMR. I am sure that RIO has discussed buying these assets before, especially as they would have been well in the mind of Alcoa when they made a full bid for WMC at $10.20, as a buyer to offload these unwanted assets to (non-core for Alcoa).

The sum of parts valuation is now about $9, the day prior to the demerger, the stock was trading at $8.20. Most of the gains have been seen in the share price of WMR since then. Well, What has changed? I think not much, and I still believe that if either company gets taken over, it will be AWC at the low part of the Alumina cycle. Remember, RIO have a history of buying bargain assets, I argue that WMR at this price is not a bargain. Base metals are ticking higher from their lows, and do look good on a chart, but WMR is trading at cyclical highs on takeover panic buying and the Gold price, which they are not highly leveraged to. THEREFORE GO SHORT WMR, But why not through the following derivatives strategy: A SHORT COLLAR



SELL A MARCH $4.50 CALL	$0.16
BUY A MARCH $4 PUT	$0.18
TOTAL COST	$0.02

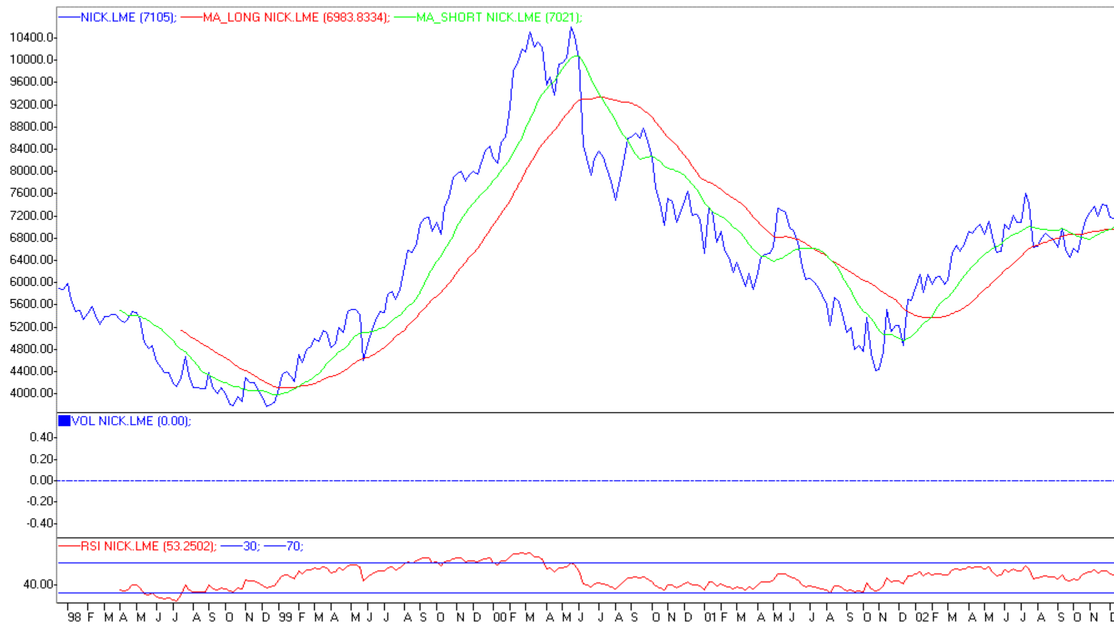
Ideally I would like the stock to trade well below $4 prior to the end of March, as my bought Put would be trading “In The Money” and my sold call will expire worthless.

This position holds less risk than a “Synthetic Short” position at $4.25 as your short Call is “Out Of The Money”. The position has unlimited downside. With my view that the stock is overpriced, I think that my down-side on expiry would be no more than 50c per share, and that would only happen with a takeover, as it is the only thing that will get the stock to $5 (MAX LOSS = $4.50 where the call is sold + 50c intrinsic value to $5). Most of my clients will Buy back the sold call if there is any threat of takeover.

I would also recommend a Short Sold position in stock to take advantage of this situation, as some options positions are quite expensive and the volatility has been extremely high since the demerger. This newsletter is specialising in derivative strategies, so I will stick with the Collar.

Finally if you don’t think that WMR is overvalued, look at the next 2 charts of WMR’s major commodities, Nickel, and Copper. The Commodities don’t look too bad, but are far from “Peak Cycle”. They are also likely to fall if there is a war.

NICKEL



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Ian Keys is an ASX Accredited Level 1 and 2 Derivatives Advisor.

PLEASE CALL IAN KEYS at HARTLEYS ON 1800 688 488 WITH ANY QUESTIONS, OR EMAIL: ian_keys@hartleys.com.au ***I am also happy to provide the Merrill Lynch reports mentioned.***

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Notes From A Presentation Given To South Sydney Discussion Group

By Lyn Morriss

The following are notes taken from a presentation given by Brendan Dickson of Challenger First Pacific. The main part of the talk was using existing shares to receive maximum benefit. This can be done via options.

An option is an obligation (not the right) to purchase a share within a pre-determined time for a pre-determined price. This can be used to generate extra income for people with shares. This can be done by writing calls on existing shares.

There are many companies that can be used – eg CBA, ANZ, WBC, NAB, RIO, BHP, WMC, MIM, LHG, NCM, CNO, TLS, FOL, WOW,

Brendan recommended that you should have at lease $30,000 worth of stock to implement options – required for fees etc,

Usually you can write options during 8 months of the year – two months area related to when the company gives dividends – two months when circumstances do not allow covered calls to be written.

Brendan then spoke about several ways in which strategies can be employed.
One of the more complex one is the **Stock repair strategy,** which is where a client would like to exit a stock with no loss.

Stock repair strategy
The client had 4000 shares of stock ABC purchased at $13.88. It was impossible to write a covered call on the stock as it was trading at about $12.12.

The client bought 4 contracts (4 x 1,000 = 4,000 shares) calls at $12.00 for $0.70 per share.

Total outlay (0.7 x 4000) + $114.00 brokerage = $2914.00

The average price for 8,000 shares was (13.88 + 12.00)/2 = $12.94

There was also a dividend of $0.26 delivered during this time.

A covered call was written at $13.00 for $0.38 for 8,000 shares = Premium was $3040.00 less brokerage ($120.00).

The revenue for this transaction was $6.00.

If the share price sent below $12.00 then the maximum profit was $6.00
If the share price went above the $12.00 mark and the call option of $13.00 exercised then the $12.00 option could be exercised also and the shares delivered. This would be slightly more profitable at an extra $0.06 per share.

Bull strategy:
WOW – Woolworth's trading between $11.30 and $11.42

Write a put at $11.50 receive	$0.40 per share
Buy a put at $11.00 @	$0.13 per share
Receive	$0.27 per share

Depends if share increases or decreases in value. Maximum loss is $0.50 ($11.50 - $11.00) - $0.27 premium = $0.23 per share.

If the result goes the wrong way, you can roll it up or forward or both.

The above was based on a presentation given by Brendan Dickson, Challenger First Pacific. Lyn Morriss is the Local Discussion Group Coordinator for the South Sydney Group.

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Questions & Answers

By Cathy Kovacs

Q1. I am interested in learning about options and how that can be used in trading and investment. Would you please recommend any good books, preferably Australian books, that could help me.

There are a number of great textbooks available on options trading and pricing. They are very theoretical, though, and may not be the best source of practical information. The best Australian author is Hugh Denning, his book is called Equity Options. Hugh has many years of practical experience on both the buy and sell side of options trading.

An alternative is an American text called Option Volatility and Pricing, by Sheldon Natenberg. If you are net savy, you can visit the ASX Website (www.asx.com.au) for educational material and seminar schedules, or the Educated Investor - Investment Books website (http://www.investment-books.com.au) for text books.

Q2. Is options trading more for the wealthy or is it something that an average investor should try?

Whether you are going to trade options or not, should not be determined by your level of wealth, but rather by your level of experience and your objective. You should only trade options if you understand the basics. To open an options trading account with a broker you must sign an "Undertanding Options" Agreement declaring you have read and understood the "Understanding Options" Handbook.

One cost barrier to trading options may be that the minimum option contract is for 1000 options. If you can't afford this, then warrants, which are like options but issued by banks and traded on the ASX, have no minimum contract size.

So, average investors can definitely use options and warrants to trade, as long as you know what you are doing.

Cathy Kovacs is a Division Director in the Equity Markets Group of Macquarie Bank.

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