# International Securities Exchange

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For the sake of simplicity, the examples that follow do not take into consideration commissions and other transaction fees, tax considerations, or margin requirements, which are factors that may significantly affect the economic consequences of a given strategy. An investor should review transaction costs, margin requirements and tax considerations with a broker and tax advisor before entering into any options strategy.

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Any strategies discussed, including examples using actual securities price data, are strictly for illustrative and educational purposes and are not to be construed as an endorsement, recommendation or solicitation to buy or sell securities.

# Outline

- Credit spreads defined
- Why an investor would use credit spreads?
- When should credit spreads be implemented?
- The risk and reward of credit spreads
- A brief summary of the foreign exchange market
- Brief description of ISE FX options
- How can credit spreads be implemented using ISE FX options?

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# Spreads Definition

- The simultaneous buying and selling of at least two different strikes.  The objective is to profit from the changing relationship of the spread itself

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# Types of spreads

- Bull call (debit spread)
- Bear call (credit spread)
- Bull put  (credit spread)
- Bear put (debit spread)

# Let's concentrate on credit spreads

- **Bear call spread-** Sell the lower strike call and buy the higher strike call as a hedge

- **Bull put spread-** Sell the higher strike put and buy the lower strike put as a hedge

# Why use credit spreads?

- An investor is hoping to earn money by selling options by selling spreads
- The use of spreads allows for a pre-defined risk
- Unique tradeoffs are created by selling one option and buying another option as a hedge
- Hopefully the spread will narrow after it is sold and the investor can earn a profit
- The ultimate goal is to keep the full amount of the credit received

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# The use of credit spreads

- Credit spreads can be used by investors looking to increase income in their portfolios
- A full understanding of the strategy is very important
- Most importantly the credit spreads strategy should complement your overall market forecast

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# Complementing your forecast with the appropriate credit spreads strategy

- If an investor is bullish- Bull put spreads may be the preferred credit spread strategy
- If an investor is bearish- Bear call spreads may be the preferred credit spread strategy

# Risk and reward of credit spreads

- The maximum profit is the net credit earned when the transaction was initially implemented
- The maximum profit can only be earned if both legs of the spread expire worthless at expiration (assuming the spread was not bought back prior to expiration)

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# Risk and reward of credit spreads

- The risk of selling credit spreads is the spread can widen further to its maximum level
- The largest amount an investor can lose when selling a credit spread is the difference between the two strike prices less any premium received

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# Selection of strikes and months

- The selection of strike prices and months should be based on the investor's forecasts
- The options market pricing is based on risk and reward scenarios, out-of-the-money spreads will be quoted at lower prices with a higher probability for remaining out-of-the-money compared to at-the money spreads that will be quoted at higher quotations but with a greater chance of expiring in-the-money

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# Selection of strikes and months

- Risk and reward must always be considered prior to entering any options transaction
- The selection of timing should be based on each investor's forecasts
- OTM option spreads with less time will tend to be quoted at lower prices compared to OTM spreads with more time

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# ITM, ATM, OTM which is best for sellers?

- Each spread has its own risk reward characteristics
- ITM spreads have the highest (given short time durations) prices and highest probability of remaining in the money
- ATM spreads have lower prices relative to ITM and less probability of expiring in the money at expiration
- OTM spreads have the lowest prices of the three types, they also have the lowest probability of expiring in the money at expiration

# Risk and reward for credit spreads

- Understanding probability can help investors select the best spreads to sell based on their own financial goals and their own risk tolerances

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# Option spreads can be used in many markets

- Equity option spreads
- ETF option spreads
- Equity broad index option spreads
- Equity narrow based index option spreads
- Foreign exchange option spreads

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# What is FX?

- Foreign Exchange is a currency market where the trading of one currency against another takes place. It is often referred to as Forex or FX.
- The foreign exchange market is the largest most liquid and most influential market in the world

# What moves currency markets?

- If a country's economic outlook improves, there will be a surge of interest and international investors will move money into the economy and thus drive up the value of its currency. Because of this, currency traders pay close attention to indicators that follow the health of an economy

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# What is a “Good” currency?

- A currency that creates confidence
- Retains value by maintaining purchasing power
- Keeps intermediate and long term interest rates at a level that sustains economic growth because they factor in low expectations of future inflation

# Foreign exchange

- Equity markets can sometimes be used as a key indicator for movement in the Forex market. As technology has enabled greater ease with respect to the migration of capital, investing in global equity markets has become far more economical.
- Often correlations develop between a country's equity, bond and real estate markets and its currency
- If the markets are rising, investment dollars are coming in to seize the opportunity. Alternatively, falling markets will have domestic investors selling their shares of local publicly traded firms only to seize investment opportunities abroad

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# Views on FX can be implemented at ISE

- Using ISE cash settled FX options your views on FX can be easily implemented through the using of many of the familiar options strategies including using credit spreads

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# Why Trade FX options?

- You can make a forecast on any of the SEC approved currency pairs and place the appropriate trade using ISE FX options
- For example, if you feel the U.S. economy is strong and will further strengthen and the European economy is weak and will further weaken you can execute that forecast using ISE cash settled FX options.  You can also reverse that forecast
- Or, an investor desires to hedge a particular currency risk
- Unlike most markets where you buy something outright, FX you are always buying one currency and selling another (currency pair)

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# How do I make my FX forecasts?

- If you are concerned about too much financial exposure to a certain currency an option hedging strategy may be appropriate
- Or, if an investor has a view on a specific currency, the investor may want to “pair” that currency with another currency with the reverse view
- If you are familiar with equity options, think of currencies as a macro-economic view, rather than the micro-economic view for individual equities

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# Features Of ISE FX Options

- Options on exchange rates
- U.S. dollar based
- .50 strike prices
- Premium quoted in U.S. dollars
- European Exercise
- Cash-settled
- Noon Settlement/Option Friday
- Noon Buying Rate FRB of NY
- Available in Conventional Brokerage Account
- Continuous Two-Sided Quotes
- Trading Hours 9:30 – 4:15

# ISE trading convention

- What is a US Dollar Worth relative to another currency
- The trading instrument is dollar relative, if you are bullish you buy calls if you are bearish buy puts.
- For option sellers if you are bullish sell puts if you are bearish sell calls

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# Initial ISE FX Offerings (Sept 11)

- USD/EUR (ticker symbol, EUI): 72.46
  (0.7246* 100)
- USD/GBP (ticker symbol, BPX): 49.31
  (.4931*100)
- USD/JPY (ticker symbol, YUK) 113.72
  (113.72* 1) the rate modifier is 1 for JPY
- USD/CAD (ticker symbol, CDD) 105.21
  (1.0521*100)

# ISE FX pairs

- EUI- 72.46 U.S. Dollar/Euro
- BPX- 49.31 U.S. Dollar/British Pound
- YUK-113.72 U.S. Dollar/Japanese Yen
- CDD-105.21 U.S. Dollar/Canadian Dollar

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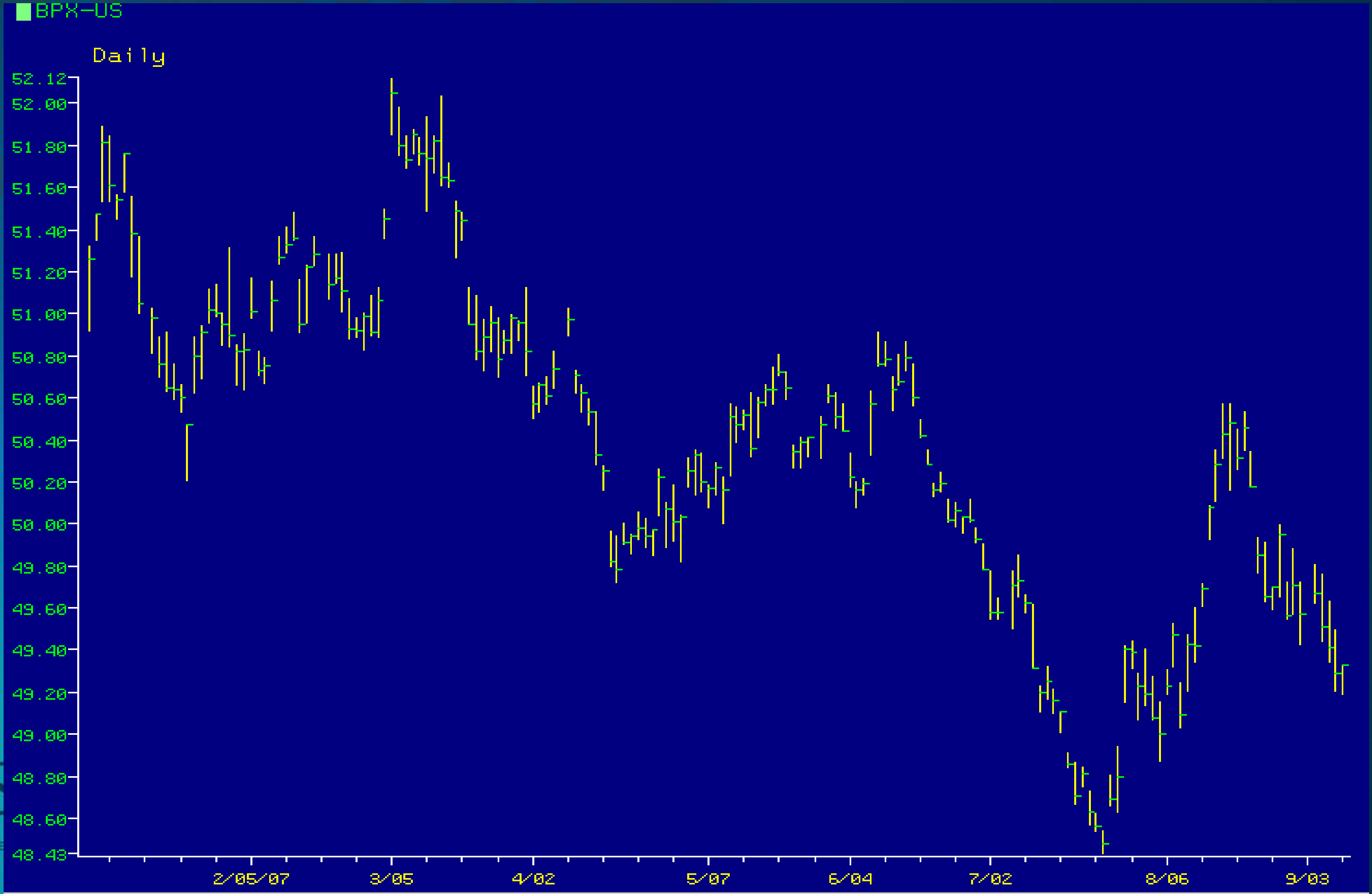
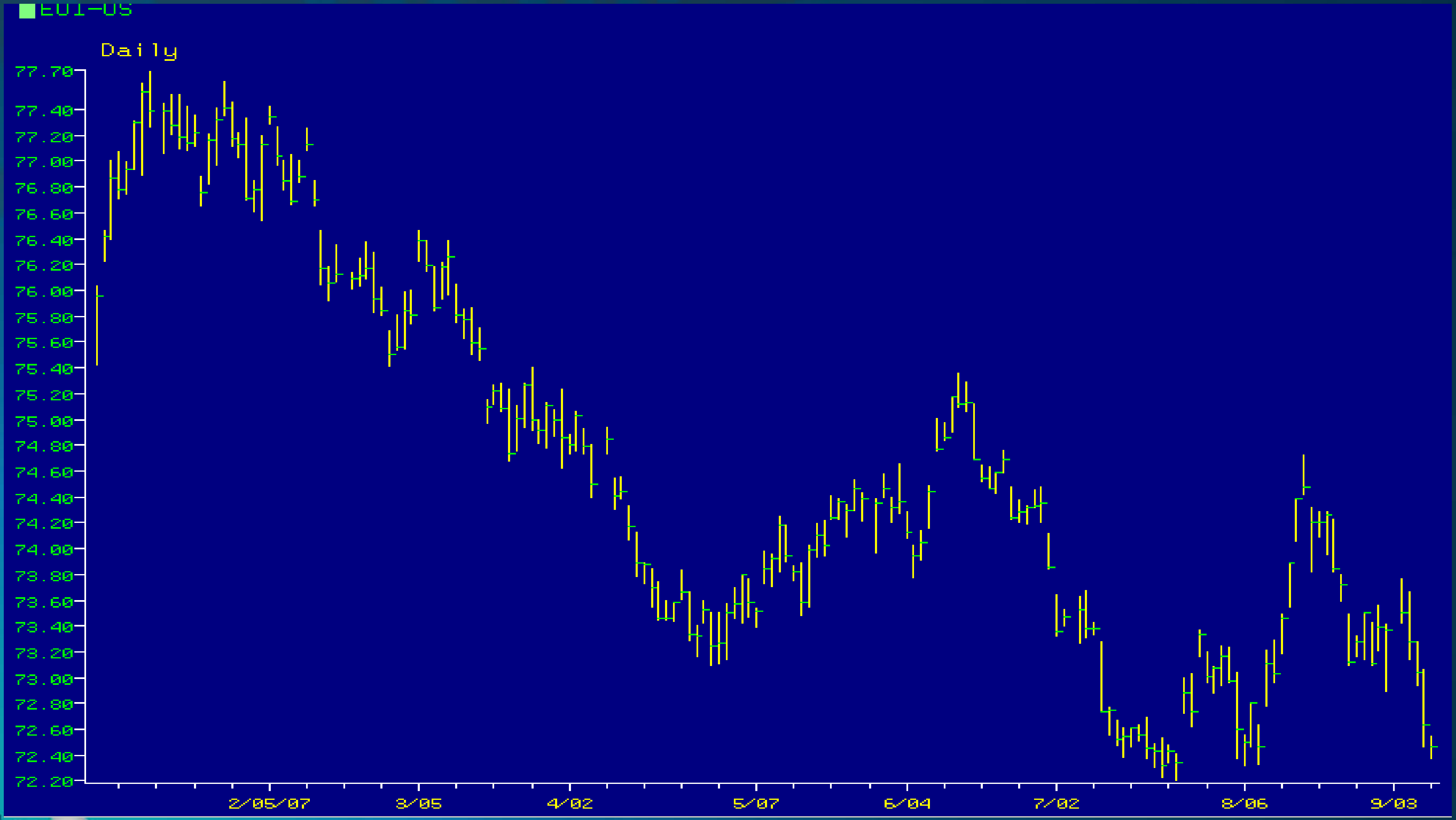
# BPX


BPX-US
Daily
52.12
52.00
51.80
51.60
51.40
51.20
51.00
50.80
50.60
50.40
50.20
50.00
49.80
49.60
49.40
49.20
49.00
48.80
48.60
48.43
2/05/07
3/05
4/02
5/07
6/04
7/02
8/06
9/03

# EUI

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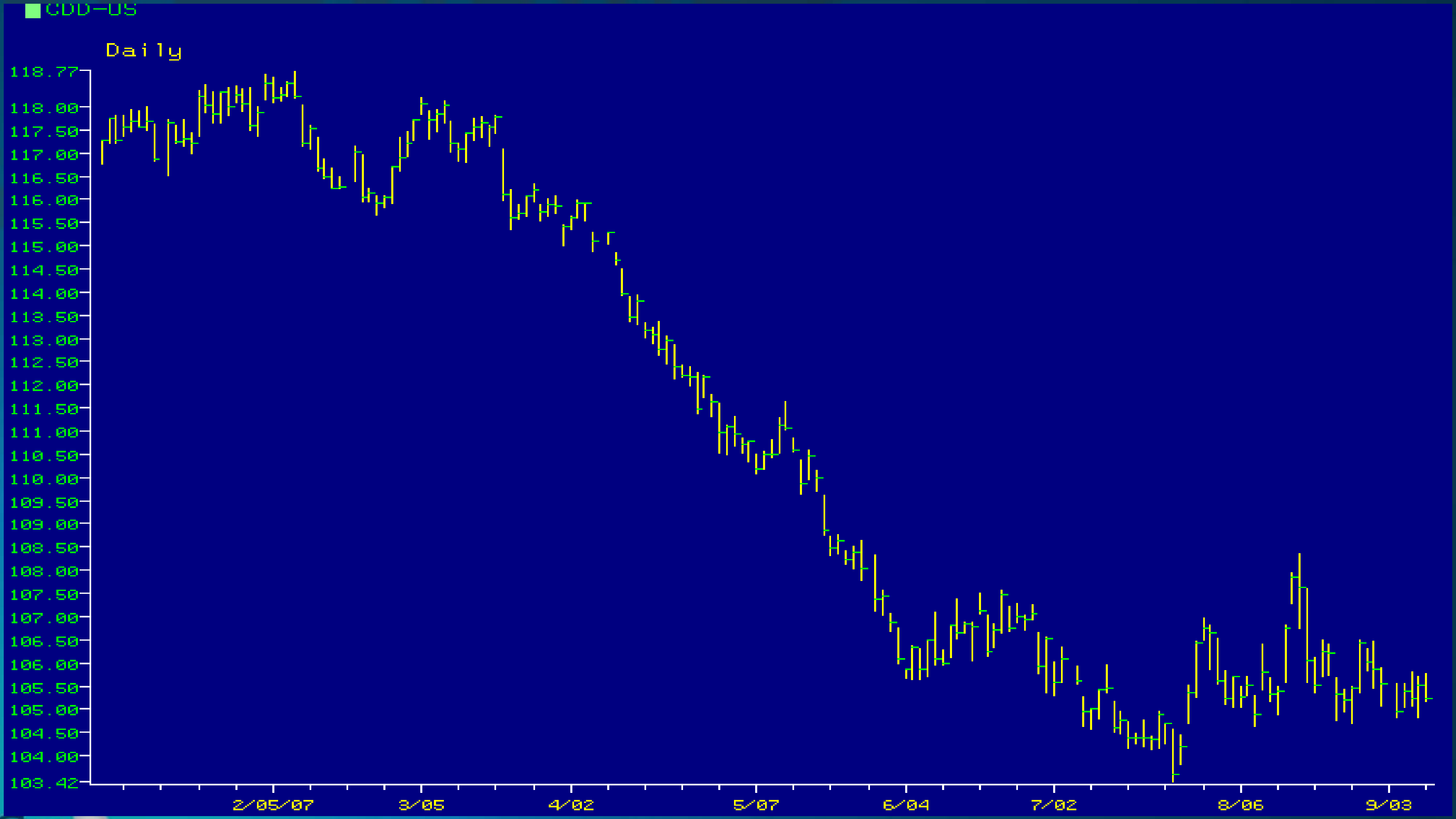
# CDD

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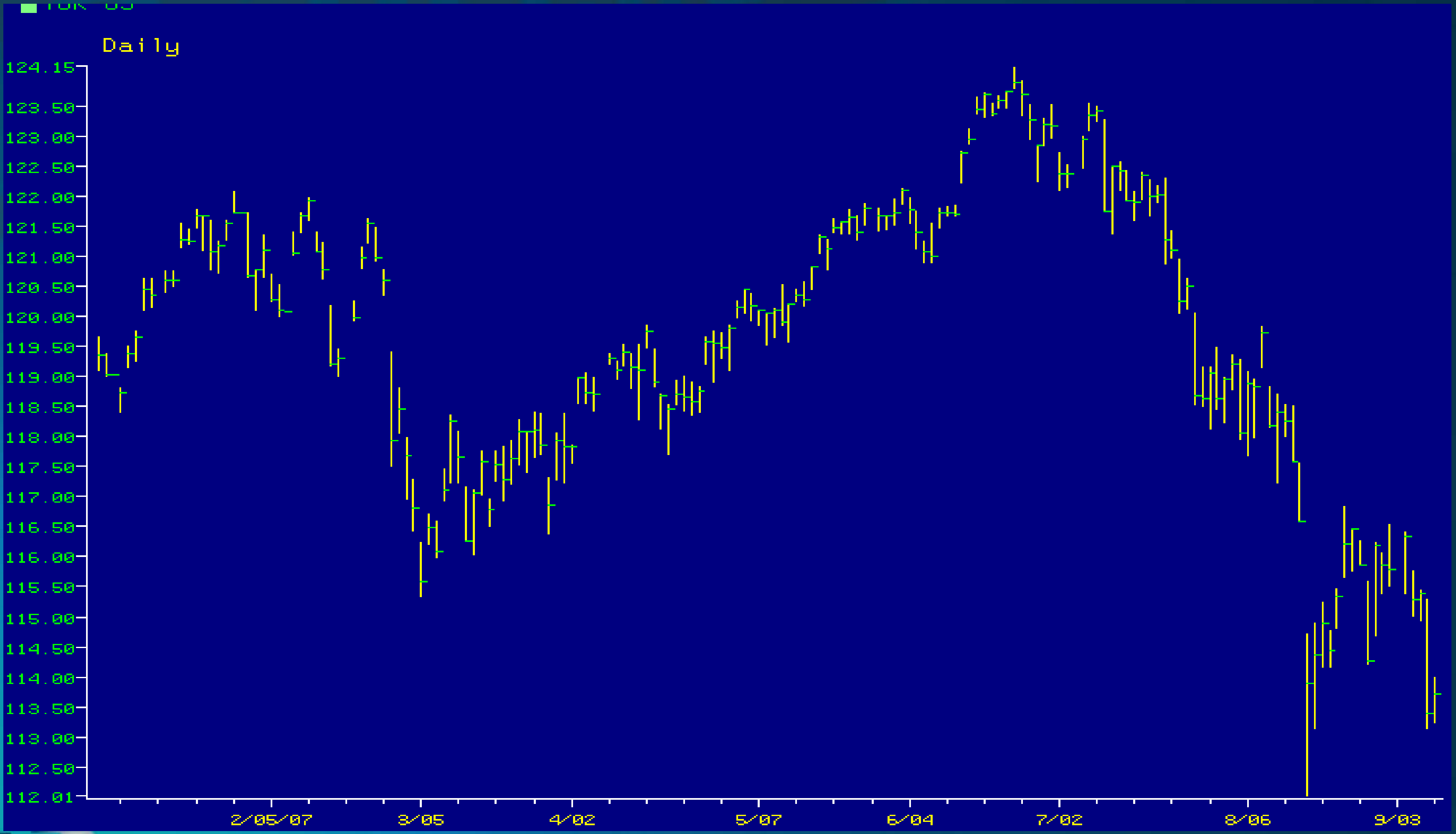
# YUK

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# Recent implied volatilities as of early August

| | Last month | 6 weeks ago |
|---|---|---|
| • EUI is approximately | 6.5% | 6.5% |
| • YUK is approximately | 9.8% | 8.7% |
| • BPX is approximately | 7.0% | 7.8% |
| • CDD is approximately | 8.5% | 8.3% |

Source: Ivolatility.com

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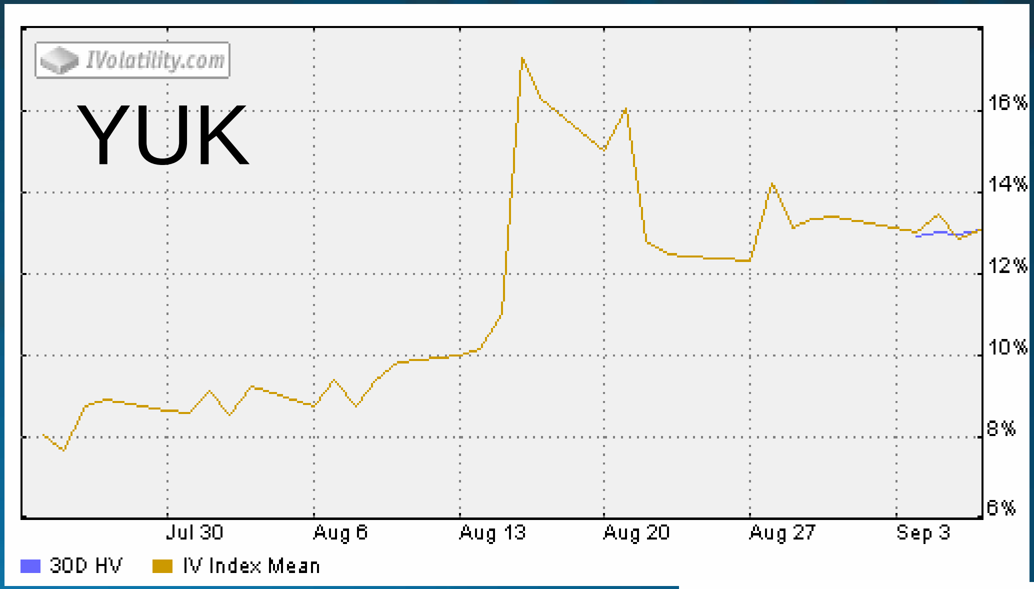
# YUK and CDD implied volatilities





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## **Bearish** on the US dollar, looking for some income? How about selling 2 month YUK call spreads?

- YUK reference 113.72
- One example selling the 110/114 YUK call spread for $2.60
- If unchanged value 1.12

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# P&L of 110/114c spread at expiry (sold at @2.6)

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 106 | 108 | 110 | 112 | 114 | 116 | 118 | 120 |
| 0 | 0 | 0 | 2 | 4 | 4 | 4 | 4 |
| 2.60 | 2.60 | 2.60 | 0.60 | 1.4 | 1.4 | 1.4 | 1.4 |

## **Bearish** on the US dollar, looking for some income? How about selling 2 month YUK call spreads?

- YUK reference 113.73
- Sell 112/115 spread for $1.35
- If unchanged value 0.38

# P&L of 112/115 YUK call spread at expiry

(sold at @1.35)

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 106 | 108 | 110 | 112 | 114 | 116 | 118 | 120 |
| 0 | 0 | 0 | 0 | 2 | 3 | 3 | 3 |
| 1.35 | 1.35 | 1.35 | 1.35 | 0.65 | 1.65 | 1.65 | 1.65 |

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**Bearish** on the US dollar, looking for some income?
How about selling 2 month 115/118 YUK call spread?

- YUK reference 113.72
- Sell out of the money (115/118) for $0.80
- If unchanged 0.80

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# P&L of YUK 115/118c credit spread at expiry
(sold at @0.80)

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 106 | 108 | 110 | 112 | 114 | 116 | 118 | 120 |
| 0 | 0 | 0 | 0 | 0 | 1 | 3 | 3 |
| 0.80 | 0.80 | 0.80 | 0.80 | 0.80 | 0.20 | 2.20 | 2.20 |

**Bullish** on the US dollar, looking for some income?
How about selling 2 month YUK put spreads?

- YUK reference is 113.72
- Sell the 116/110p spread for $2.80
- If unchanged value 0.52

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# P&L for 116/110 2 month YUK put spread

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 106 | 108 | 110 | 112 | 114 | 116 | 118 | 120 |
| 6 | 6 | 6 | 4 | 2 | 0 | 0 | 0 |
| 3.20 | 3.20 | 3.20 | 1.20 | 0.80 | 2.80 | 2.80 | 2.80 |

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## **Bullish** on the US dollar, looking for some income? How about selling 2 month YUK put spreads?

- EUI reference is 113.72
- Sell the 116/113 spread for $1.75
- If unchanged value 0.53

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# P&L for 116/113 2 month YUK put spread at expiry sold @($1.75)

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 106 | 108 | 110 | 112 | 114 | 116 | 118 | 120 |
| 6 | 6 | 6 | 4 | 2 | 0 | 0 | 0 |
| 1.25 | 1.25 | 1.25 | 1.25 | 0.25 | 1.75 | 1.75 | 1.75 |

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**Bullish** on the US dollar, looking for some income?
How about selling 2 month YUK put spread?

- YUK reference 113.72
- Sell the 112/110 YUK put spread for $0.60
- If unchanged value 0.60

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# P&L for 112/110 2 month YUK put spread at expiry sold @($0.60)

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 106 | 108 | 110 | 112 | 114 | 116 | 118 | 120 |
| 2 | 2 | 2 | 0 | 0 | 0 | 0 | 0 |
| 1.40 | 1.40 | 1.40 | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 |

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# Summary of trading credit spreads using ISE FX options

- ISE FX options allow you to implement your views on the foreign exchange market
- ISE FX options are European style, hence they cannot be exercised early (an advantage for option sellers)
- European style does not allow for early exercise, but investors can always close out their option positions on any trading day prior to expiration

# Summary of trading credit spreads using ISE FX options

- Trading credit spreads allow for the premium selling of options with a limited pre-defined risk
- The goal of selling credit call or put spreads is to the potential narrowing of original spread sold
- A full understanding of the credit spread strategy is recommended
- Most importantly the credit spread strategy should complement your overall market forecast

# Commonly asked questions regarding ISE FX Options

- Can I get price charts? Yes, Bigcharts.com has all of the ISE traded pairs available
- Do the “greeks” work? Yes, if an investor inputs the correct interest rate and dividend yield (US risk-free rate) option calculators will work and of course the volatility
- Can I get volatilities for the ISE FX pairs? Yes, Ivolatility.com has the data on their site
- How much do these options cost? Same as equity options, $1.50 options costs $150
- Are the quotes available? Yes, your brokers have the quotes, Bigcharts.com also Yahoo Finance carries the options but you must use ^CDD, ^YUK, ^EUI and ^BPX

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