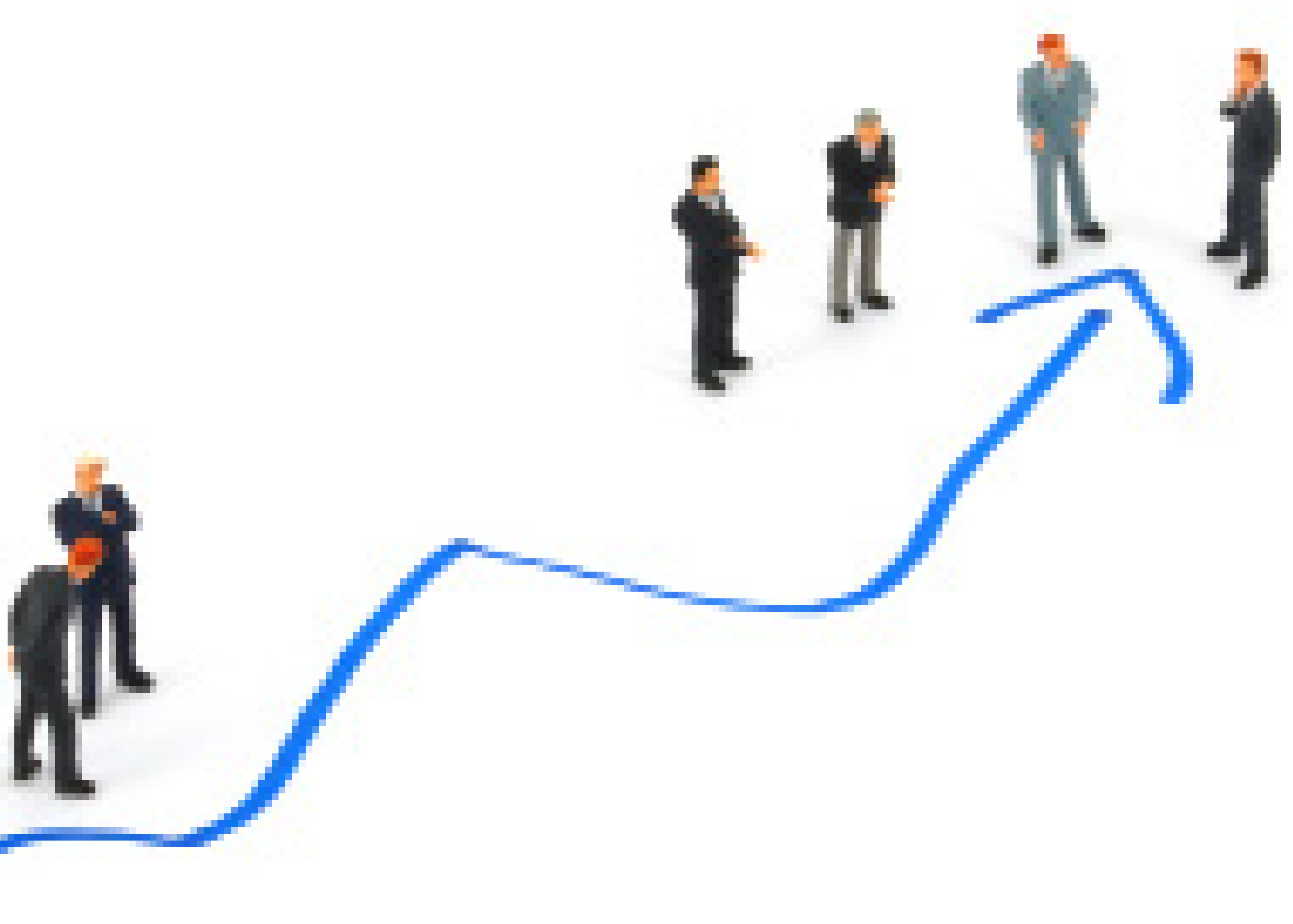
traders circle

EXCHANGE TRADED OPTIONS

Learn how to complement your existing portfolio and trade all market conditions with Exchange-Traded Options.



PH: 03 8080 5788
WEB: www.traderscircle.com.au
EMAIL: admin@traderscircle.com.au

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Exchange traded options

Exchange Traded Options are a financial product that the ASX provides that are classified as a derivative and a leveraged financial product.

What are derivatives?

A derivative's value derives from an underlying variable asset. Options derive their value from a company share or an index.

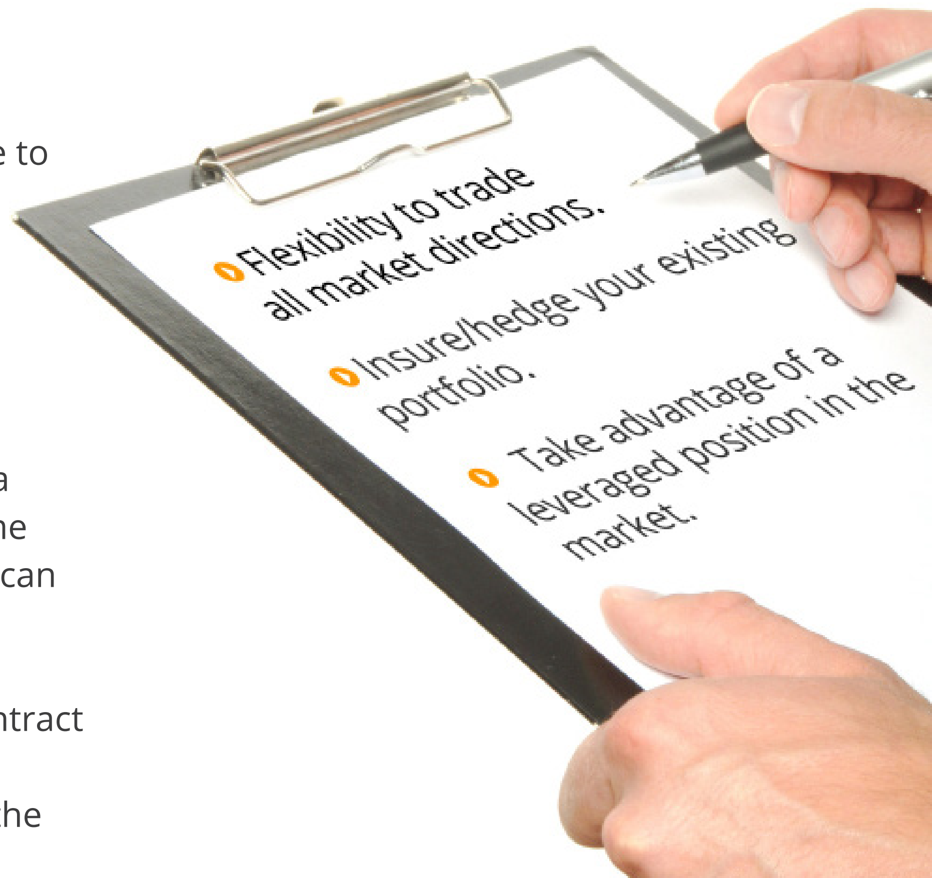
What is leverage?

Leverage occurs when financial instruments can increase exposure to price movements.

What are Exchange Traded Options?

An option is a contract in which the buyer has the right but not the obligation to buy or sell a stock at a stated price (strike price) at any time during the life of the option (American Style).

You can view it as an insurance contract between a buyer and seller where the buyer has the right to take up the contract if and when they choose, where the seller will receive a premium to insure the buyer.



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WEB: www.traderscircle.com.au
EMAIL: admin@traderscircle.com.au

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Types of options

There are two different types of options:

Put Option
The buyer of a put option has the right, but not the obligation to sell a stock at a stated price (strike price) at any time during the life of the option (American Style).

Call Option
The buyer of a call option has the right, but not the obligation to purchase a stock at a stated price (strike price) at any time during the life of the option (American Style).

For example:

You have the right but not the obligation to sell stock at 37.00 which is .50c more than you can on the market

Put option 37.00 strike price

BHP Trading at 36.50

You have the right but not the obligation to buy stock at 36.00 which is .50c cheaper than you can on the market.

Call option 36.00 strike price

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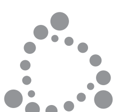

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Calls vs. Puts

Call Options

Call options gain value as the share price of the underlying asset rises, as it will give the buyer the right but not the obligation to buy a parcel of shares for a lessor value than it is worth on the market.

The more the share price rises the more the call option will gain in value.

Put Options

Put options gain value as the share price of the underlying asset falls, as it will give the buyer the right but not the obligation to sell a parcel of shares for a greater value than it is worth on the market.

The more the share price falls the more the put option will gain in value.

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How can you use options?

Exchange traded options have various uses for both traders and investors.

Some of these uses include:

- Insuring a Stock or Portfolio
- Locking in a buy or sell price of a stock
- Income Strategies using the Collateral Value of a portfolio
- Trading a view of the underlying stock

Why trade options?

Exchange Traded Options give traders the advantage of trading a leveraged position in different directions of the market.

With education and experience, an options trader can profit from:

Directional strategies for a rising market.

Time decay strategies in a sideways or channeling market.

Directional strategies for a falling market.

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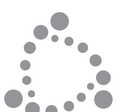

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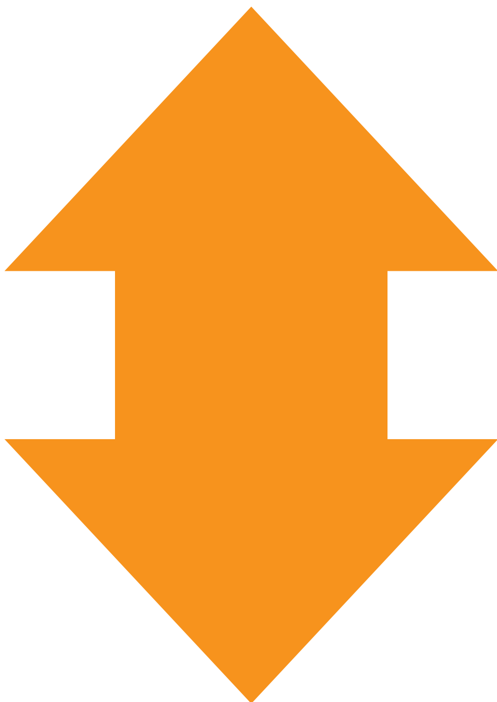
How can you use options?

An options trader can profit when the share price either rises or falls - as long as it moves in either direction.



Multi-directional strategies that can profit if the share price moves in either direction.

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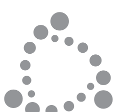

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Options expiry

All options have an expiry date and a trader or investor has the ability to choose an expiry month. The more time until expiry, the more time value that the investor will need to pay.

Therefore a stock will have a series of strikes to choose from that will range over a series of months.

An option buyer has two choices:

1. Sell the option contract to someone else before the expiry to realise a profit or loss. (Trading the option)

2. Choose to exercise their right to buy or sell stock at any time up until the expiry day of the option (American style). This is often used by investors as a strategy to buy or sell shares.

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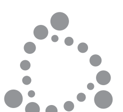

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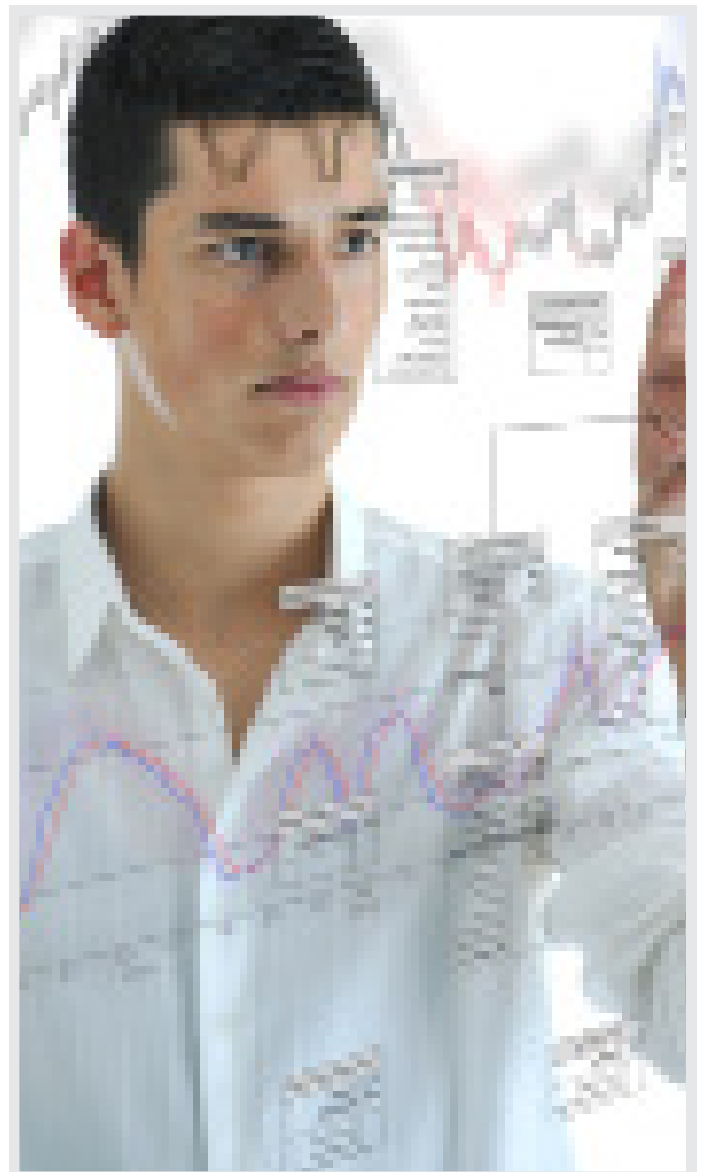
Spread Trading

Spread trading uses a combination of different options contracts to allow a trader to tailor their trade to a specific view of a stock, or market direction.

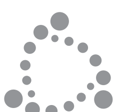
This can consist of a combination of options that can be bought to open and sold to open, with differing strike prices and/or expiration dates.



The clear benefits of spread trading over just trading single options is the ability to profit from different market conditions not just direction.

An experienced options trader has the ability to profit from a rising market, a falling market and a neutral or sideways market.

There are spread strategies that can even profit if the market rises or falls which is a great alternative if you don't have a directional view but your view is that the market will move.



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Types of spread strategies

There are two main types of spread strategies. These two types of spreads can be set up in many different ways to create different strategies in the market.

An options trader profits from a spread trade because both legs move in value at different rates and will have different intrinsic values on expiry day.

Credit Spreads

Bull Put Spread

This is where we sell an option at a higher value than the bought option. This will result in receiving money from the market to open the trade.

Bear Call Spread

This is where we sell an option at a lower value than the bought option. This will result in receiving money from the market to open the trade.

The best-case scenario with these strategies is for the options to be out of the money on expiry day so that they expire worthless and you keep the credit received.

Investors commonly use credit spreads as they can use the collateral value of their portfolio to cover the risk.

Debit Spreads

Bear Put Spread

This is where we buy an option at a higher value than the sold option. This will result in paying money to open the trade; the sold option will offset the cost and effects of time decay of the bought.

Bull Call Spread

This is where we buy an option at a lower value than the sold option. This will result in paying money to open the trade ; the sold option will offset the cost and effects of time decay of the bought leg.

The best case scenario with these strategies is for the options to be in the money on expiry day so that we close the trade and receive back from the market more than we paid.

Traders commonly use debit spreads because there are more choices to repair a trade if it goes against them.

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An example Credit Spread

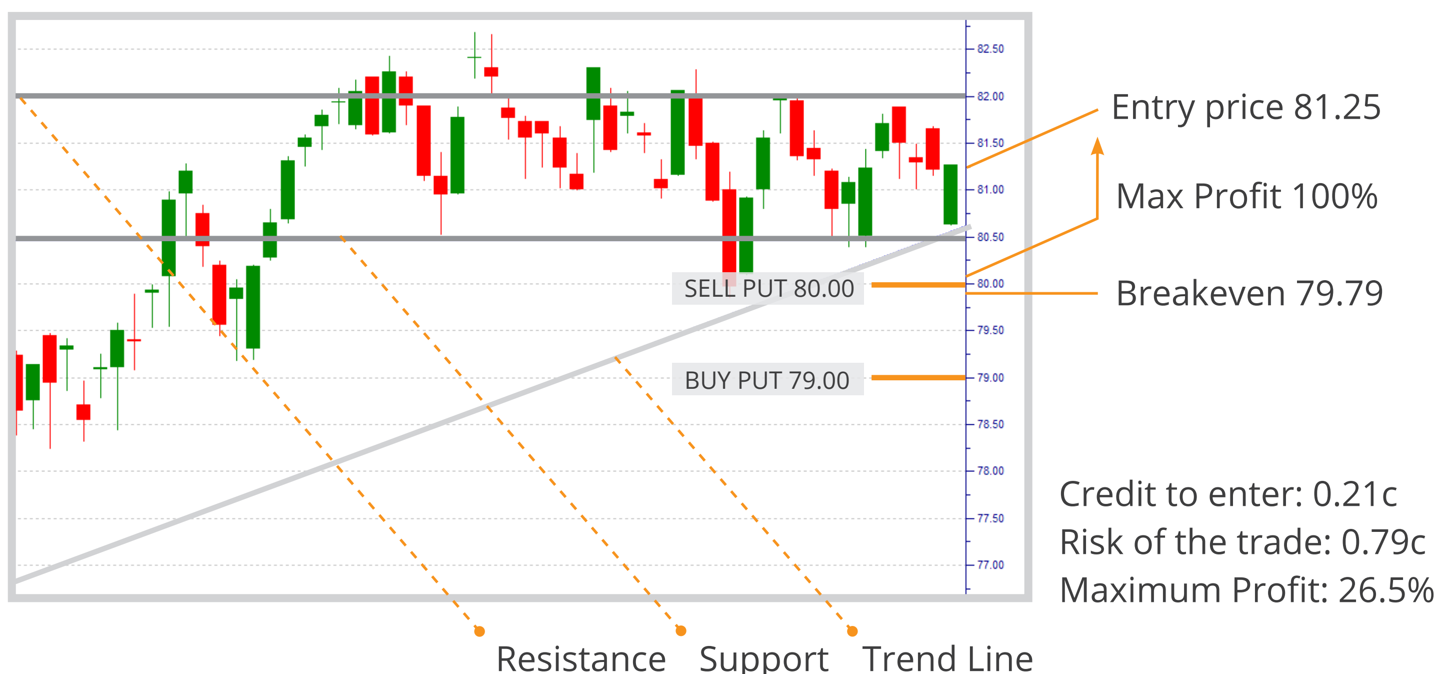
This is a chart of CBA, where the overall trend is up and we expect the share price to move sideways to slightly bullish.

To set up bull put spread, we simultaneously buy one put option (buy put is 79.00) and sell another put option (sell put is 80.00) which has a higher strike price. We receive a credit on entry on this strategy.

The ideal outcome will be the share price remaining above the higher strike, meaning the options expire worthless and we keep the credit received.

We entered when the share price was $81.25 if it is at least above $80 on expiry we make maximum profit of 26.5%. Therefore if the share price goes up, sideways, or it can even fall $1.25 and we will still make a profit on expiry.

The breakeven point on expiry is $1.46 below the current share price.
Using a credit spread allows you to benefit from time decay, which in this example means we are less reliant on a directional move.



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An example Debit Spread

This is a chart of SUN, where the overall trend is up. We expect the share price to rise moderately.

To set up a Bull Call Spread, we sell one call option and buy another call option at a lower strike price. We pay to enter this strategy.

To realise a profit from this strategy, the share price needs to be above your break even point on expiry day. If the share price is above the sold leg on expiry you will realise the max potential, a large movement will give us the opportunity to close out quickly with profit.

Entry Price: 0.28c Debit
Potential Profit: 0.22c or 78%

In this example if the share price moves up quickly as planned, then we can close the trade and take our profit. However, if at expiry it is still at the same point we bought in we are able to take a small profit or breakeven.

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Covered Calls

Covered Calls are an options strategy that can be used to generate cash using the collateral value of the shares in a portfolio.

A covered call strategy involved selling call options to open, above or at the share price in the view that the share price will go sideways to bullish.

Call buyers have the right to buy the underlying stock.

A Call seller will receive a credit to enter a contract with the buyer in which they will be ensuring the buyer that they will sell stock to them at the strike price of the contract.

To make profit from this trade we set the strike higher than the price paid for the stock as well as the current share price. As a result, if the option is exercised, you will sell your stock for a profit, plus you keep the credit received to enter the contract.

If the share price goes sideways and is below the call strike on expiry, the option expires worthless and you keep the premium that you received in opening the contract.

Example covered call

It is May and we own 1,000 XYZ shares that we bought at $35.10.

XYZ has been trading sideways and our view is that it will continue in that pattern or rise a little in the next few months. The share price is trading at $36.00 so we decide to sell to open a call option with a strike of 36.50 in June for .60c Credit per option.

As we own 1,000 Shares, that means we can sell 1,000 call options or 10 contracts as we can use 100% of the collateral value of the shares. This will create a credit of $600.

Sell to open 36.50 June Call for .60c CR

XYZ Current Share Price 36.00

XYZ Share Buy Price 35.10

Scenario 1: The share price falls and is trading at 34.90 on June expiry- The options will expire worthless and you keep the $600 but the XYZ shares have lost .20c of value or $200 so you profit $400 even though the share price has fallen.

Scenario 2: The Share price rises to $37.00 on June expiry we get exercised on the option so we will sell the stock at 36.50. We will make $1.40 on the stock or $1,400; we also keep the Credit from the call option we sold of $600. This equates to be a $2,000 profit for the month.

Scenario 3: The share price falls and is trading at 34.00 on June expiry- The options will expire worthless and we keep the $600 but our XYZ shares have lost 1.20 of value or $1,200. If I didn't sell the call I would have lost 1,200 but by selling the calls I have only lost $600.

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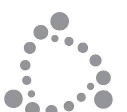
Covered call risk

The risk is the same as holding the shares, as if the share price falls then the value of the shares will go down. (The credit from the options will help reduce the loss compared to just holding the shares).

There are many different ways of managing and timing the entry of a covered call, which will yield different results.

You need to be prepared to sell the stock if needed for this trade to work. This can be a problem if you have a large capital gains tax obligation in that year.
Covered calls can only be done on a stock that has exchange traded options.



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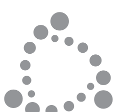
Sold Puts

Sold puts are an options strategy that can be used to generate cash using the collateral value of the shares in a portfolio or to generate cash when buying shares in a portfolio.

Put buyers have the right to sell the underlying stock.

Put sellers will receive a premium to enter a contract with the buyer in which they will be ensuring the buyer that they will buy stock from them at a strike price that they can choose.

To profit from this you will need to set the strike lower than the current market value and at a level at which you are prepared to buy the underlying stock.



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Sold Puts Example One

Using the Sold put to generate premium with the view of buying the stock.

It's May and we are interested in XYZ shares as the stock has formed an uptrend after a recent sell off. The share price is trading at $35.00 so we decide to sell to open a put option with a strike of 34.00 in June for .60c Credit per option.

We have $30,000 in a trading account ready to buy the stock if needed. So that means we can buy 882 XYZ shares at 34.00. ($30,000 / 34.00 = 882). We sell 800 put options or 8 contracts at .60c and receive a premium of $480.

XYZ Current Share Price 35.00

Sell to open 800 34.00 June Put for .60c CR

Scenario 1: The share price goes sideways and is above 34.00 on June expiry, the options are out of the money and will expire worthless. You keep the premium of $480.

Scenario 2: The share price trades lower at 33.70 on June expiry and the option gets exercised. We purchase 800 XYZ shares at a price of 34.00 at a cost of $27,200 and we keep the $480 premium from the put options. In effect we have purchased the shares at 33.40 instead of 34.00.

PH: 03 8080 5788
WEB: www.traderscircle.com.au
EMAIL: admin@traderscircle.com.au

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Sold Puts Example Two

Trading the sold put whilst holding the stock.

It's May and we own 1000 XYZ shares. We are bullish as the shares have bounced off a support level and are looking to continue on an uptrend. The share price is trading at 35.00; we bought the stock at 34.50. We decide to sell to open a put option with a strike of 34.00 in June for .60c Credit per option.

We can only use 70% of the share value as collateral to cover the risk of selling the puts. As the share value is 35.00 we can use 24.50 of the share value as collateral or 24,500. (1000 x 35.00 x 70% = 24,500)

XYZ Current Share Price 35.00

XYZ Share Buy Price 34.50

Sell to open 600 (6 contracts) 34.00 June Put for .60cCR ($360)

Scenario 1: The share price goes sideways and is above 34.00 on June expiry, the options are out of the money and will expire worthless. You keep the premium of $360.

Scenario 2: The share price trades lower at 33.70 on June expiry and the option gets exercised. We purchase 600 XYZ shares at a price of 34.00 at a cost of $20,400 and we keep the $360 premium from the put options.

In effect we have purchased the shares at 33.40 instead of 34.00. On expiry day, we will need to sell the shares in the market match or the next morning. If we sell them for more than 33.40 we have made a profit.

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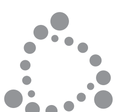
Sold Puts Considerations

Put sellers must be financially and psychologically prepared to buy the underlying stock.

The risk is the same as holding the shares because if the share price falls, you will have to buy the share at a higher value than they are worth. You will lose the full value of the strike price if the share price goes to zero.

There are many different ways of managing and timing the entry of selling puts which will yield different results.

Selling Puts can only be done on a stock that has exchange traded options.



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Hedging

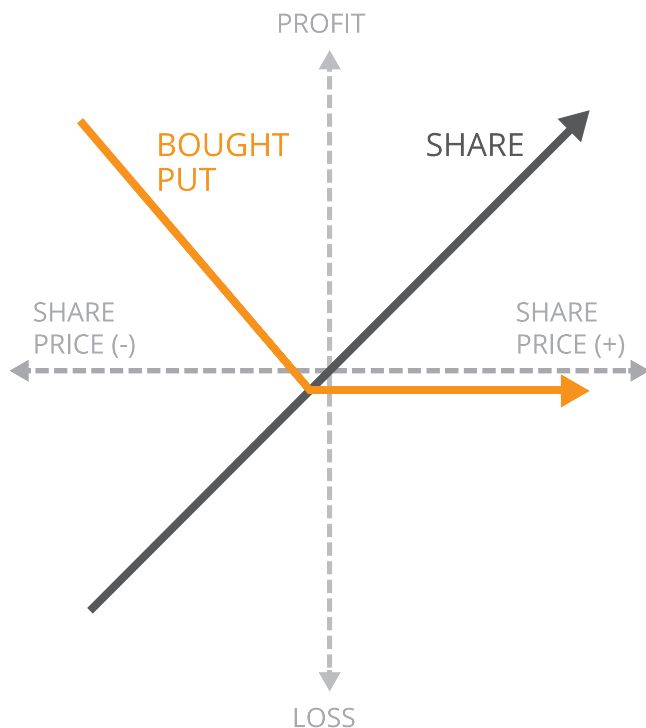
One of the most popular uses for exchange-traded options is to hedge (insure) the value of equity holdings.

To achieve this, the simplest way is to buy put options. This will mean that when there is a rise in share prices, the value of your equity holdings will increase and you will lose the premium you pay for the puts.

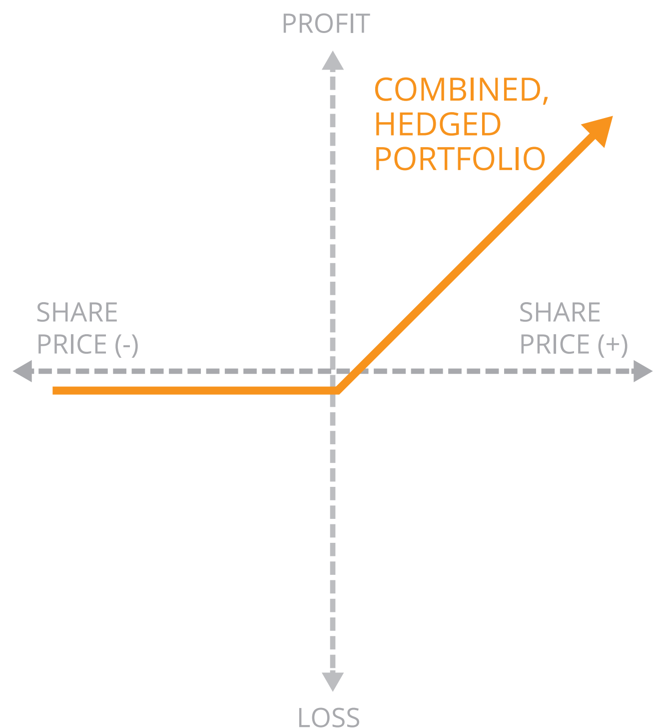
When there is a share price decrease, whilst your equity's value will fall, the value of your puts will increase. In this way, you are insured against a fall in the share price.

You can also employ the use of index options to cheaply achieve the same hedging effect over a market portfolio.

Bought put vs. share:



Combined Portfolio:



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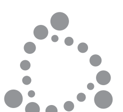

ETOs vs. Binary Options

Binary options are a relatively new class of option contract where the payoff or outcome of the option is binary in nature: I.E they will always have two possible outcomes/eventualities.

Most binary options can only be purchased from issuers, usually online trading platforms and brokers.

The majority of binary options are not standardised products and they aren't usually traded on exchanges and secondary markets.

They must therefore be held until expiry where settlement will occur as per the terms of the contract.

The maturity horizons of binary options also deviate from those of exchange-traded options (ETOs).

Whereas many ETOs will have an expiry once a month, for up to four-years into the future, binary options will usually expire some time on the date of purchase.

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ETOs vs. Binary Options

In Australia, all extant binary options providers lack the transparency and credibility of government-regulated exchanges. It is for this reason that we, as professional traders, choose instead to trade exchange-traded options (ETOs).

The benefits of trading ETOs over binaries are plentiful: opening and closing positions is easy, counterparties are numerous and prices will tend toward supply and demand equilibrium. The derivative nature of ETO payoffs also enables the use of multiple-legged and repair strategies. Allowing traders to effectively customise their risk exposure, confident in the knowledge that they can liquidate their positions for at, or near fair value. There are also very strict rules and laws, designed to safeguard individual investors, governing market integrity and interaction.

Binary options on Australian securities can only be purchased directly from issuers, who also act as the broker and counter party. Pricing models are highly opaque and usually contain a "built-in" spread, increasing costs and reducing profits. There is also a lack of secondary markets, meaning that positions must usually be held until expiry. These limitations, combined with short investment horizons and binary payoff nature also ensure that multi-leg or repair strategies are infeasible. When you also consider that these binary issuers generally have no rules or regulations governing the trading of their binaries, it is easy to see that retail traders are at a disadvantage.

The criticisms of binary options and their providers do not simply question the market and pricing mechanics, they also identify the likelihood for fraud and scams to be committed. Indeed, in a 2013 report, the American Securities and Exchange Commission (SEC) detected numerous cases of fraud involving binary providers, leading them to issue a directive warning individuals of the considerable risks involved in trading binary options.

ETOs vs. Binary Options

A quick look at Binary Options compared to Exchange Traded Options:

	Exchange-Traded Options (ETOs)	Binary Options
Regulated Market	✓	✗
Standardised Contracts	✓	✗
Exchange Traded	✓	✗
Secondary Markets	✓	✗
Market integrity rules	✓	✗
Counterparty credit protection	✓	✗
Pay-off	As derivative function of underlying price	Binary win or loss
Expiry	Short to Medium Term (Once a month, up to 4 years into the future)	Ultra short-term (30 seconds up to 1 month from trade)

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Glossary of terms

Bearish
A trader or investor believes that a market, security or industry will fall in value.

Bullish
A trader or investor believes that a market, security or industry will rise in value.

Directional Strategies
Trading strategies that are designed to increase in value when the underlying asset moves in the predicted direction but will fall in value if it doesn't move or moves in the opposite direction.

Equity
In the context of trading, equity is owned assets such as stock.

Multi-Directional Strategies
A strategy where you can benefit if the underlying asset moves in more than one direction (up or down but not sideways).

In-the-Money
Call options - when the value of stock is above the strike price.

Put Options – when the value of stock is below the strike price.

Out-of-the-Money
Call options - when the value of stock is below the strike price.

Put Options – when the value of stock is above the strike price.

Portfolio
A portfolio consists of a group of financial assets such as shares which are owned by an investor.

Resistance
Resistance is a level in charting that a share or index will lose buying momentum when reached. This is a level where you expect sellers to come back in and buyers may lose confidence.

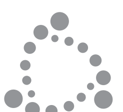
Support
Support is a level in charting that a share or index value will lose selling momentum when reached. This is a level where you expect that buyers will come back into market.

Glossary of terms

Strike (Strike Price)
An option strike or strike price is the value that a call option can be bought, or a put option can be sold.

Time Decay
The reduction in an options price based on the decrease in time to expiry.

Trend
The trend of a share, industry or index is the general direction it moves over time.



Warnings and important information.

Any advice contained in this communication is general only and does not consider your objectives, financial situation or needs, and you should consider whether it's appropriate for you. If you are thinking about acquiring a financial product, you should consider our Financial Services Guide (FSG) at www.traderscircle.com.au and the relevant Product Disclosure Statement (if there is one available) first.

Trading options is not suitable for everyone. There is a risk that you can lose more than the value of a trade or its underlying assets. You should only act on our recommendations if you are confident that you fully understand what you are doing.

Past returns do not reflect future returns, and it is also possible to make significant losses. We employ expert traders and use strategies that maximise returns and minimise risk. However, there is always a risk of loss when trading and investing. This is general information, and is not prepared for your specific investment objectives, financial situation or needs. Consult a licensed investment adviser before making investment decisions. TradersCircle Pty Ltd, ABN 65 120 660 497 is a corporate authorised representative of Emerald Financial Group Pty Ltd, AFSL number 241041.