



## Exchange-Traded Fund Options

In addition to offering options on iUnits™ S&P®/TSX™ 60 Index Fund, the Montréal Exchange offers to investors options on the following iUnits Funds of Barclays Global Investor: S&P/TSX Canadian Energy Index (XEG), S&P/TSX Canadian Financials Index (XFN), S&P/TSX Canadian Gold Index (XGD) and S&P/TSX Canadian Information Technology Index (XIT).

These index funds, which track the valuation of the underlying index, provide for an investment in a basket of equities through a unique security that is traded like any stock. These securities are extremely popular with investors and options on these funds were launched on April 21, 2003.

Options based on the index funds are similar to equity options except for the underlying which is 100 fund units reflecting the performance of a particular sector. The purchase of units on a particular market sector allows investors to be exposed to the different Canadian market sectors. However, these securities are not protected from market fluctuations.

The introduction of iUnits options provides investors an opportunity to hedge and protect their portfolio, and also to use these options in speculative investment strategies. As an example, we will discuss a hedging strategy with the options on iUnits™ S&P®/TSX™ 60 Index Fund (XIU) since there is data available. This strategy can also be used with sectorial index funds.

Assume that you own 1,000 units of the XIU index fund for which you have paid \$34 per unit. The XIU is currently trading at \$36.75. You want to protect your profit as well as generate income and you are prepared to sell at \$37.50. Thus, you keep your 1,000 XIU units and sell 10 XIU calls Sep 37.50 at \$1.70, and collect \$1,700 in premium income.

If, at expiry, the XIU remains lower than or equal to \$37.50, the options will expire worthless. You will keep your XIU units as well as your premium and will have generated an additional 5% return for this period.

Your maximum profit will be attained if, at expiry, the XIU price is at your strike price of \$37.50. In that case, the options that you have sold will be assigned and you will sell your units at \$37.50, generating a profit of \$3,500 [1,000 x (\$37.50 - \$34)]. You will also keep the premium of \$1,700 received from the sale of the options. Your return is now 15.29% for this period.

As you can see, you were able to increase your portfolio return by pocketing the premium received from the sale of the covered calls as well as reducing its volatility.

## Listing

At the opening of trading on March 31, 2003, the Exchange listed the following equity option class: Great-West Lifeco Inc. (GWO).

At the opening of trading on April 21, 2003, the Exchange listed the following exchange-traded fund option classes:

- Options on iUnits S&P/TSX Canadian Gold Index Fund (XGD)
- Options on iUnits S&P/TSX Canadian Financials Index Fund (XFN)
- Options on iUnits S&P/TSX Canadian Information Technology Index Fund (XIT)
- Options on iUnits S&P/TSX Canadian Energy Index Fund (XEG)



## REMINDER - Mx Road Shows for Investment Advisors

The pan-Canadian tour of the Exchange to meet investment advisors is taking off.

The Exchange wishes to explain and clarify the features

equity options offer and how they can help in the achievement of financial objectives. Some places are still available for the staging points in Ontario and the Western provinces. This is your last chance to register. Participants are eligible for the draw of a **selection of fine wines** (value of \$500) for each staging point.

**Equity Options Road Show**  
**Not to be missed**  
[www.m-x.ca/road](http://www.m-x.ca/road)  
 or 1-800-361-5353, Ext. 319

**a selection of fine wines**  
 (value of \$500)  
 for each staging point.

## Question of the Month

### If I sold calls during the last year, what will the tax implications be on the premium I received?

You must first determine if the transaction will be taxed as income or as capital gain or loss. Please refer to Form IT479R from Canada Customs and Revenue Agency to make this distinction.

#### If the transaction is considered to be on income account:

If the option is exercised, the premium received is declared as income in the year of election. If the option is not exercised and is near expiry, the premium is declared as income in the year in which the option expires. If you close your position by repurchasing the option in the market, the premium received is deducted from the

premium paid to close the position and the resulting capital gain or loss is accounted for in the year in which the option is closed out.

#### If the transaction is considered to be on capital account:

If the option is exercised, the premium is added to the value of the disposition of the underlying shares in the year in which the exercise has occurred. If the option expires worthless, the premium is considered as a capital gain during the year in which the premium is received and finally, if the option is repurchased in the market, the premium paid is considered as a capital loss during the year in which the option is repurchased.

Reference: Canada. Customs and Revenue Agency. *Transactions in Securities* No. IT479R

If you have a question about options, please send it to [options@m-x.ca](mailto:options@m-x.ca). Your question may be published in the next issue of this newsletter.





# Preferred Share Alternatives *by Richard N. Croft*

## When income is more important than growth

For some investors, growth is secondary to a decent income stream. And preferably one wants a low maintenance income stream. If you are in the highest marginal tax rate, good quality preferred shares offer an attractive alternative to bonds. Factoring in the federally-sponsored dividend tax credit, a 4% dividend is equal to about 6% of interest income after tax.

Mind you not all preferreds are created equal. Meaning caveat emptor... look closely at the fine print. A lot of preferreds in the market pay what look like abnormally high dividends. When you see that, pay particular attention to the details. In some cases, it may be that the preferred share has a redemption privilege. The company that issued the preferred may have the right to redeem the shares prior to maturity at a price lower than the current market price. Factor the redemption into a preferred pricing model and the yield probably comes back to earth.

Other times, it may have more to do with the underlying company. There may be some concern that the company will not be able to pay the dividends in the future. Unlike a bond, a company does not have to pay a preferred dividend in order to remain solvent. In some cases, if a company fails to pay a preferred dividend it will accrue that payment into the future. In other words, the company has to pay all missed dividends to their preferred shareholders before any dividends can be paid to the common shareholder.

In other instances, preferred share dividends do not accrue. Meaning that a company can miss a payment and you will never see it again. Companies where there is some concern about their ability to maintain a specific dividend payout will appear to have a high yield. When in fact, the yield is based on a real possibility of a phantom dividend.

As a rule of thumb, good quality preferred shares will provide about 80% of the yield available on good quality ten-year corporate bonds. That accounts for the favourable tax treatment of dividends; and the higher risk associated with dividends versus interest on bonds. In the current environment, a good quality preferred share is a yielding somewhere between 3% and 5%.

For investors who like the dividend cash flow and stability of a good quality preferred share, the options market offers some interesting alternatives. For example, writing an in-the-money covered call against a good quality dividend paying common stock can be viewed as a preferred share alternative. The sale of an in-the-money call reduces the out-of-pocket cost for the common shares and by extension, enhances the dividend yield.

As an example, consider the common shares of the Bank of Nova Scotia (symbol BNS, listed on the TSX). The stock recently traded at \$52.25 per share. BNS pays an annual dividend of \$1.60 per share. Based on the \$52.25 share price, the dividend yield is 3.07%.

That's an attractive dividend yield. But what if we were able to reduce the cost base to say, \$43.25 per share. At that price, the \$1.60 per share dividend yields 3.69%. Better than the dividend yield on many good quality preferred shares.

However, in this case, you are receiving dividends on the common shares. Presumably any dividend reduction would come at the expense of the common shareholder before it would affect the preferred shareholder. On the other hand, with the common shares, there is the potential of a dividend increase. Something BNS has done on a fairly regular basis over the past couple of years.

By selling an in-the-money call, you immediately gain downside protection and are left with some limited upside potential. The limited upside potential being the net out-of-pocket cost for the BNS common shares, versus the strike price of the call.

Here's how it works. Keeping with the BNS example, you buy the shares at \$52.25 per share and write, say, the January (2004) 45 calls for \$9.00 per share. The out-of-pocket cost for this trade is \$43.25 (\$52.50 share price less \$9.00 premium received = \$43.25), giving us the 3.69% dividend yield. Of course this assumes that the stock is not called away before January 2004. If this happens, you will not receive all of the dividends, but you would have made your maximum profit sooner.

The maximum profit is based on the difference between your out-of-pocket cost and the strike price of the call. If BNS is trading above \$45 per share in January 2004 – ten months from now – the call will be exercised, and you will deliver your BNS shares to the call buyer at \$45 per share. That nets you an additional \$1.75 on this trade, which is taxed as a capital gain. Think of that as the redemption price for your common shares.

Assuming the stock is called away at \$45 per share, you pocket a 4.04% capital gain over the next ten months [(\$45 strike price divided by \$43.25 out-of-pocket cost for BNS) minus 1], plus the 3.69% dividend yield (assuming the company continues to pay the dividend and the stock is not called away early). The total return on this trade - if the stock remains above \$45 per share - is 7.73%.

Most of the major Canadian bank stocks provide similar rates of return and dividend yields as the BNS example. And the common shares of all the major Canadian banks would be considered blue chip. Keeping with the high quality we demand for our preferred share alternative.

## Key Statistics March 2003

Contracts	Volume		%	
	Mar. 2003	Jan. – Mar. 2003	Jan. – Mar. 2002	Change
Interest rate derivatives	777,441	2,397,840	1,637,653	46.4%
Index derivatives	256,365	425,990	323,142	31.8%
Equity derivatives	508,036	1,587,773	1,574,332	1.0%
<b>TOTAL MARKET</b>	<b>1,541,842</b>	<b>4,411,603</b>	<b>3,535,127</b>	<b>24.8%</b>

Contracts	Open positions		%
	year-to-date 2003	year-to-date 2002	
Interest rate derivatives	339,443	229,806	47.7%
Index derivatives	87,993	71,402	23.2%
Equity derivatives	782,266	712,963	9.7%
<b>TOTAL MARKET</b>	<b>1,209,692</b>	<b>1,014,171</b>	<b>19.3%</b>

### Canadian equity options market – trading volume by sector\*

Sectors	Volume		Volume	Change	Average
	Mar.	Trade volume %			
Materials	112,306	22.64%	89,669	25.25%	5,911
Industrials	68,685	13.85%	30,261	126.98%	8,586
Telecommunications	11,216	2.26%	20,320	-44.80%	2,804
Consumer Discretionary	9,582	1.93%	11,520	-16.82%	1,916
Energy	59,114	11.92%	37,635	57.07%	5,911
Financials	118,730	23.94%	85,765	38.44%	8,481
Health Care	16,021	3.23%	12,551	27.65%	4,005
Technology	91,554	18.46%	77,506	18.13%	10,173
Utilities	7,173	1.45%	9,141	-21.53%	2,391
Consumer Staples	1,606	0.32%	1,060	51.51%	535
<b>TOTAL</b>	<b>495,987</b>	<b>100.00%</b>			

\* Sectors breakdowns are based on the S&P/TSX indices

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