CANADIAN EQUITY DERIVATIVES

Quarterly Newsletter - April 2014

MANAGER'S COMMENTARY

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TMX | Montréal Exchange

Richard Croft

Richard Croft, President of R. N. Croft Financial Group, Inc., a company that provides personal portfolio management and consulting services to individual investors, has been in the securities business since 1975. He has been collaborating with the Montréal Exchange as an instructor for several years in addition to developing two options writing indices (MX Covered Straddle Writers' Index and MX Covered Call Writing Index) and publishing options commentary on MX blog (optionmatters.ca). Richard is also a regular contributor to the *MoneyLetter*, where his articles focus on using individual stocks, mutual funds, and exchange-traded funds within a portfolio model. Most recently, he co-authored *Protect Your Nest Egg*, a Canadian best-seller on portfolio building.

Martin Noël

Martin Noël holds an MBA in Financial Services from the Université du Québec à Montréal since 2003. The same year, he received his Fellow of the Institute of Canadian Bankers and was awarded the Silver Medal for his superior level of performance in the completion of the Professional Banking Program.

Martin began his career in the derivatives industry in 1983 as an options market maker for various brokerage firms on the floor of the Montréal Exchange. He later became an Options Specialist and ultimately an independent trader. In 1996, he joined the Montréal Exchange as Options Market Supervisor where he had the opportunity to contribute to the development of the Canadian Options market. Since May 2009, he is President of Monetis Financial Corporation, which specializes in professional trading and financial communication.

Trading Calendar

PRODUCT	LAST TRADING DAY	EXPIRATION
Equity options	April 17, 2014	April 17, 2014
Options on ETFs	April 17, 2014	April 17, 2014
Equity options	May 16, 2014	May 16, 2014
Options on ETFs	May 16, 2014	May 16, 2014
Equity options	June 20, 2014	June 20, 2014
Options on ETFs	June 20, 2014	June 20, 2014

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The Montréal Exchange and The Options Industry Council (OIC) hosted the inaugural Options Conference for Investment Advisors and Portfolio Managers in Toronto, Montréal and Vancouver in March. The conference series is the result of a continued partnership between the two organizations, aimed at enhancing awareness and knowledge of exchange-listed options.

Over 230 industry professionals reunited at the first edition of the Options Conference to share best practices and exchange ideas on how options can be utilized to achieve their clients' investment objectives. The conference also welcomed representatives from areas of compliance and risk management, reflecting an increasing need for participating firms to gain insight and receive more extensive training on alternative investment solutions.

The conferences featured experts and specialists from reputable firms and organizations including **BMO Asset Management**, **CIBC Wood Gundy**, **Desjardins Securities**, **Horizons ETFs**, **Morgan Stanley**, **Raymond James**, **RBC Dominion Securities**, **TD Waterhouse** and **Theta Strategies Capital**. Several topics were explored including option strategies, taxation and client education, though the most recurring theme was differentiation. Discretionary practice and in-depth product knowledge were also identified as key determinants of success in implementing a successful "optioncentric" business model. However, for those wanting to leverage existing expertise, portfolio managers from actively managed funds also joined in the discussion to present popular overlay strategies.

In Canada, a total of 25,000 individuals are registered representatives with the Investment Industry Regulatory Organization of Canada (IIROC) of which only 20% have completed their options licensing course. Among the 5,000 advisors and portfolio managers with the ability to offer and trade options for their clients, only an estimated 5 to 10% have adopted options as an integral part of their business model. This positions the product as a niche offering within an increasingly competitive industry!

Many advisors admitted that the adoption of options helped them grow their business significantly and ensured their ability to retain existing clients. This is in line with the key findings presented in "**The Financial Advisor's Use of Options: A Benchmark Study**" published by the **Options Industry Council** in 2011. The study revealed that advisors who use options have significantly more successful practices in terms of assets under management. The study also highlighted that clients were at the heart of the discussion, making it essential for advisors to explore alternative solutions to enhance yield and mitigate risk more efficiently.

Thank you for making the first Edition of the Options Conference for Investment Advisors and Portfolio Managers a success! If you have comments or suggestions regarding content or would like to participate to next year's conference as a panellist or speaker, please contact Josiane Lanoue at **jlanoue@m-x.ca**.

We look forward to seeing you next year!

TMX Montréal Exchange OIC The Options Industry Council

THE NEW NORM: SLOW AND STEADY

By Richard Croft

From my perspective, North America equity markets finished the first quarter as expected. The onset of tapering dampened enthusiasm for US stocks which limited first quarter gains in the S&P 500 composite index to 1.30%. Canadian equities fared better up 4.98% (ex-dividends) during the quarter based on the performance of the iShares S&P TSX 60 index fund (my proxy for large cap Canadian stocks).

I suspect, as I discussed in the previous quarterly newsletter (see article entitled: T.I.N.A.), Canadian stocks will continue to out-perform US equities through most of 2014. Effectively closing the performance gap resulting from QE-III!

That in itself does not imply that Canadian equities will continue to rise. Canada can still close the performance gap by falling less than US equities in a market correction. Because of that, Canadian advisors would be well served to keep one eye on the US economy in recognition of how it may impact Canadian stocks.

For example, Canadian advisors need to recognize that US investors are slowly coming to grips with a new norm. Valuing companies based on metrics like revenue growth and earnings. Something we have been doing in Canada for some time.

Those metrics will become increasingly important as margins get squeezed by an inability to raise prices in a low inflation environment and the diminished likelihood of further productivity improvements.

To that point, it is important to understand the inflation debate. Analysts have been warning about an inflationary spike due to the unprecedented surge in the money supply resulting from three rounds of quantitative easing. Too much money chasing too few goods!

However, in this case, the surge in global money supply is illusory. In reality, the money that central banks pumped into their respective economies never got to where it was intended. It ended up on the balance sheets of money center banks in the form of excess reserves. In the US for example, the banking system is sitting on US $2.5 trillion in excess reserves.

What gives rise to inflation is an increase in the velocity of money. That comes from banks loaning money to real consumers who buy real goods and services. Whatever the reason - burdensome regulatory oversight, consumer's reluctance to borrow - loan growth is sluggish and there appears to be no appetite for change.

Another factor that may actually reduce inflationary expectations is US health care reform. The cost of private health care in the US has been rising at an average annual rate of 8.3% for the past twenty years. Four times the rate of inflation!

While not passionate on this issue, the liberal side of my brain (it is a very small part) believes that publicly funded Obamacare will reign in costs over time effectively reducing health care's impact on the US inflation numbers.

Depending on your point of view, low inflation can be good or bad. Inflationary spikes help reduce the bloated debt that global governments have been amassing. On the other hand, there can be a strong case made that in a low inflation environment interest rates will remain abnormally low.

On the interest rate debate, rates may not rise as fast as some analysts have forecast. Typically, when central banks telegraph their intent to raise their overnight lending rate, that action causes rates along the yield curve to rise. This time not so much!

We saw a spike in Canadian mortgage rates and yields on medium term US government bonds when the Fed hinted at tapering last June. And rates continued to rise through the remainder of 2013 topping out at 3% on 10 year US government treasuries. They have been falling since the beginning of the year and I suspect, unless there is a significant bump up in short term rates, central bank tightening will have little impact on the rest of the yield curve.

What this leaves us with is trying to evaluate Canadian companies in light of a new slow growth low inflation environment. Seek value in companies that can improve margins through enhanced efficiencies; i.e. technology, health care including pharmaceuticals and transportation. Avoid companies that do not do as well in a low inflation environment; i.e. manufacturers, consumer durables, commodities and energy.

You might also focus on companies that pay solid dividends and have a defined policy for maintaining their dividend payout ratios. To that end think utilities and banks!

Sale of covered call options on National Bank of Canada

At the time this article was written, on March 26, 2014, shares of National Bank of Canada (NA) were trading at a unit price of $44.34, after slumping to $41.26 on February 3. This level is halfway from its historic peak of $46.96 reached on November 15, 2013 and could represent a resistance zone, given the fact that the STO89 (Stochastic Index over 89 sessions) weekly momentum indicator is in decline. The combination of these two factors leads us to believe that NA's favourable growth rate may drop off and stand still or slightly decrease over the coming weeks. In such a context, investors holding NA stock in their portfolio may benefit from a defensive strategy offering slight protection in case of decline, as well as the opportunity to capitalize on a potential upswing. The covered call options strategy on NA shares consists in selling one call option contract for every block of 100 shares held. The strike price level for call options sold is a compromise between the desired capital gain and the desired degree of protection. In this case, the sale of NA JUL $44 call options at $1.25 per share would generate a maximum profit of $1.37 per share, including a dividend of $0.46, by the July 2014 expiration month (strike price of $44 - NA current price of $44.34 + premium of $1.25 + dividend of $0.46), for a return of 3.2% (10.1 % annualized). The breakeven point of $42.63 offers protection against a drop of 3.9%. The sale of NA JUL $46 call options at $0.40 per share offers protection against a drop of 1.9%, with a breakeven point of $43.48 and a potential maximum profit (with dividend) of 5.7% (18.2% annualized).

Sale of put options to take advantage of an increase on Suncor Energy Inc. shares

The price of the shares of Suncor Energy Inc. (SU) has been hovering around $37 since September 2013, most recently dipping to $34.70 on February 4, 2014, and could represent a major support level in case of decline. The STO89 (Stochastic Index over 89 sessions) weekly momentum indicator has remained above the 75 level since that time, and as long as this level does not go downward, we can conclude that the next major movement will be upward. However, since SU may continue to mark time for a while longer, investors who have confidence in SU's growth potential and are prepared to purchase shares in case of decline, could establish a bullish position by selling put options. Unlike the purchase of call options, this strategy makes it possible to benefit from the erosion of the value of the options if the stock stands still, as is currently the case. The sale of SU JUN 36 P put options at $0.80 would generate $80 per contract. This amount represents the maximum profit that can be achieved if SU remains stagnant until the June 2014 expiration month, for a return of 2.3% for the period (9.5% annualized). This put option also offers protection against a drop of 4.5% with a breakeven point of $35.20. The sale of SU JUN 37 P put options at $1.25 would generate $125 per contract. This amount represents the maximum profit that can be achieved if SU closes at a price exceeding the $37 strike price by the June 2014 expiration month, for a potential return of 3.5% (14.7% annualized). The static return, if SU treads water between now and expiration, is 3.1% (13% annualized). This put option also offers protection against a drop of 3% with a breakeven point of $35.75. The choice of put option strike price will be a compromise between the potential maximum return and the level of protection offered in case of decline.

Top 10 Most Active Option Classes (Q1 2014)

RANK	SYMBOL	Q1 2014 VOLUME	INSTITUTIONAL	RETAIL	INSTITUTIONAL %	RETAIL %
1	XIU	260,219	115,342	144,877	44%	56%
2	ATH	231,509	198,641	32,868	86%	14%
3	TD	173,305	70,592	102,713	41%	59%
4	ABX	164,463	77,119	87,344	47%	53%
5	BNS	163,429	70,824	92,605	43%	57%
6	G	162,616	74,777	87,839	46%	54%
7	SXO	153,230	78,726	74,504	51%	49%
8	RY	151,604	66,061	85,543	44%	56%
9	BMO	146,023	70,601	75,422	48%	52%
10	DGC	139,187	66,099	73,088	47%	53%

Options Trading Volume by Sector

March YTD 2014

SECTOR	% CHANGE
Energy	30.04%
Materials	28.26%
Financials	23.37%
Industrials	4.47%
Consumer Discretionary	3.57%
Telecommunication Services	3.17%
Information Technology	2.37%
Consumer Staples	2.31%
Utilities	2.05%
Health Care	0.40%
Grand Total	100%

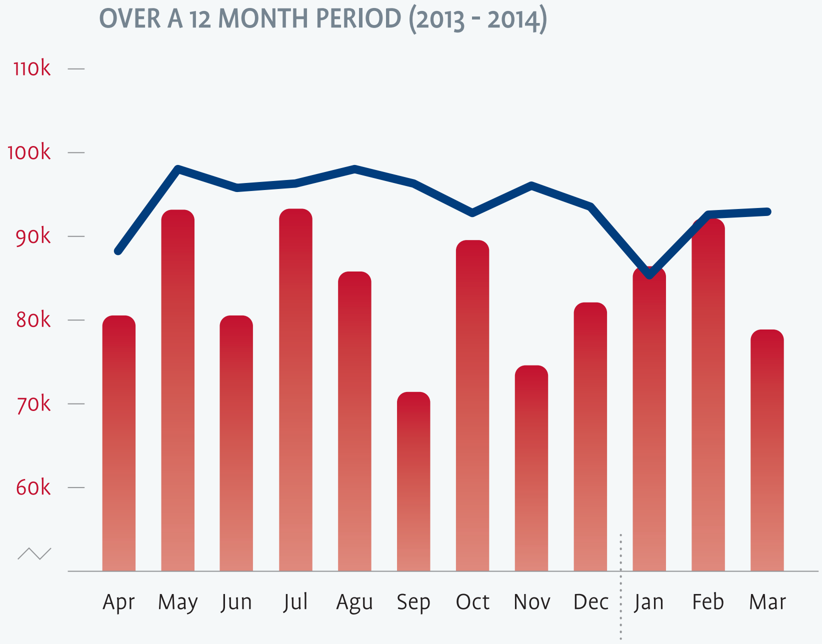
Source: Bloomberg

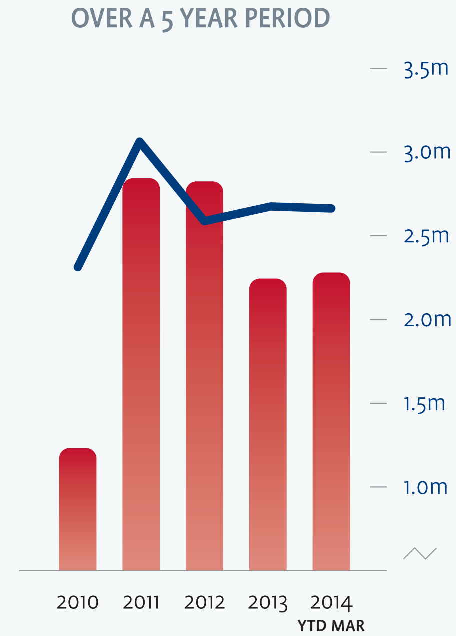
Note: Options volume from delisted or acquired companies are excluded.

Most Crossed Option Classes

RANK	SYMBOL	CROSS VOLUME
1	ATH	198,641
2	XIU	115,342
3	XFN	87,868
4	CNQ	80,923
5	FM	80,152
6	SLF	79,047
7	TX60	78,726
8	ABX	77,119
9	G	74,777
10	BNS	70,824
11	BMO	70,601
12	TD	70,592
13	DGC	66,099
14	RY	66,061
15	MFC	51,481
16	CM	51,174
17	NA	50,195
18	POT	49,660
19	TCK.B	48,449
20	SU	47,607

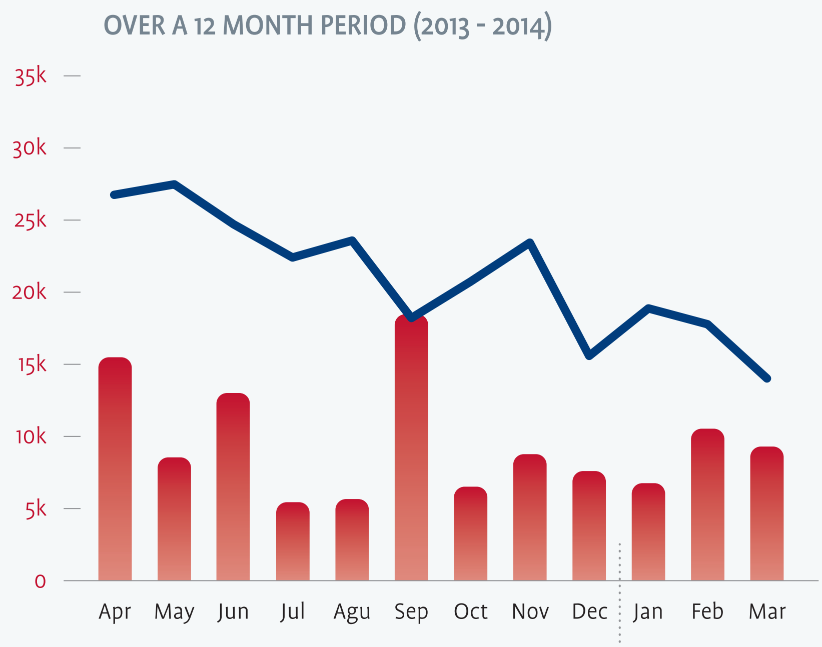
Equity Average Daily Volume and Open Interest

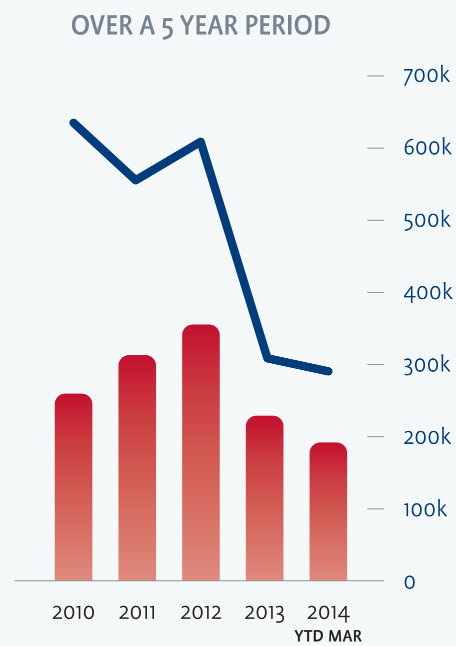




Average Daily Volume   Open Interest

ETF Average Daily Volume and Open Interest





Average Daily Volume   Open Interest

Trading Tools

COVERED CALL Calculator

OPTIONS Calculator

TMX Trading SIMULATOR

Useful Links

GUIDES

» Equity derivatives

» Index derivatives

» Currency derivatives

» Equity options tax regime

MX INDICES

» S&P/TSX 60 VIX Index (VIXC)

» MX Covered Straddle Writers' Index (MPCX)

» MX Covered Call Writers' Index (MCWX)

OTHERS

» Options List

» Put/Call Ratios

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